

Global Insight

Perspectives from the Global Portfolio Advisory Committee



Geopolitical wake-up call

With high-stakes geopolitical risks back to the fore, what does this mean for equity markets and portfolio decision-making?

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Fast track to the future



Global equity
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Bubble, bubble, toil, & trouble



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Wealth
Management

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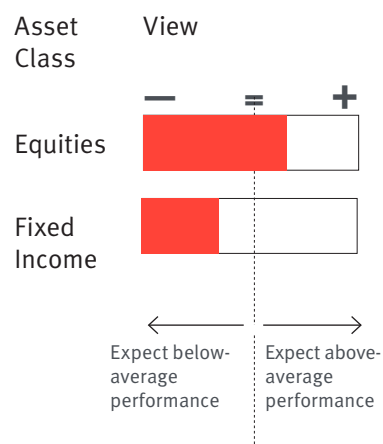
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All values in U.S. dollars and priced as of market close, August 31, 2017, unless otherwise stated.

RBC's investment stance

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See “Views explanation” below for details

Source - RBC Wealth Management

Equities

- Equity momentum slowed during the last month of summer, as is par for the course. The performance of major indexes was mixed in August. Looking ahead, there is a full plate of potential market-moving events, including fiscal deadlines in Washington, votes on U.S. tax cut legislation, NAFTA renegotiations, central bank meetings, and China’s National Congress later this autumn. Furthermore, there is still a possibility North Korea risks could accelerate.
- While we continue to advocate a modest Overweight position in global equities with a preference toward Europe, the rally of the past year provides investors an opportunity to reassess and reposition portfolios. We would trim sectors or securities that have ballooned during the rally, as there may be more attractive entry points in coming months.

Fixed Income

- Are interest rates abnormally low, signaling something more ominous ahead, or is the ultralow interest rate trend the new normal? Put us squarely in the “new normal” category. Importantly, since slow economic growth and low inflation are global phenomena, we anticipate the Federal Reserve and European Central Bank will remain patient about raising interest rates and slow to unwind unconventional stimulus. This would all but ensure the lower-for-longer global rate environment will persist.
- In our view, stretched valuations pose the greatest challenges for investors. While there are opportunities in the market, including in the credit sector, they come with patience and selectivity. What’s more, we believe the current low volatility environment is opening the door for investors to de-risk and diversify fixed income portfolios.

Views explanation

(+/=/-) represents the Global Portfolio Advisory Committee’s (GPAC) view over a 12-month investment time horizon.

+ Overweight implies the potential for better-than-average performance for the asset class or for the region relative to other asset classes or regions.

= Market Weight implies the potential for average performance for the asset class or for the region relative to other asset classes or regions.

- Underweight implies the potential for below-average performance for the asset class or for the region relative to other asset classes or regions.

Geopolitical wake-up call



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Markets are facing a simmering geopolitical pot as the U.S. and North Korea ramped up the rhetorical brinksmanship this summer. We revisit how equities reacted to past geopolitical crises, and discuss how to factor a wide range of outcomes into portfolio decisions if the showdown escalates into something more ominous.

After a multiyear hiatus, geopolitical risks are back on the table amid aggressive rhetoric between North Korea and the U.S. along with related missile tests and fresh economic sanctions.

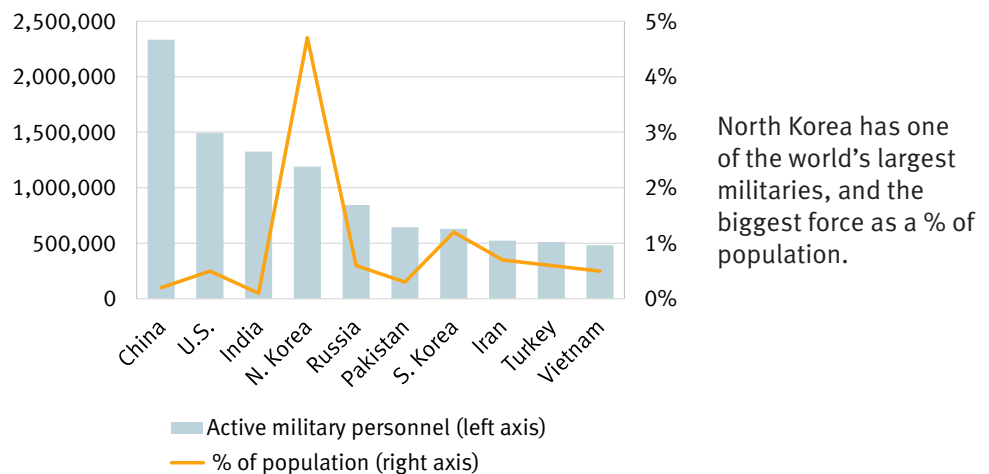
Factoring this or any credible geopolitical threat into investment decisions can be challenging given the wide range of potential outcomes, some with high stakes.

Add to that, there is an unpredictable, young leader on one side squaring off with an unpredictable, new president on the other side who campaigned on a non-interventionist foreign policy platform but is increasingly making interventionist moves in multiple regions of the world. Then there are the vital interests of South Korea along with the roles of neighboring China, Russia, and Japan.

The North Korea situation comes at a time when equity markets are sitting just beneath all-time highs and the global economy and corporate earnings continue to show signs of buoyancy. In other words, markets have good reasons to look past the geopolitical risks, as long as they don't escalate to a dangerous level.

We examine how previous geopolitical incidents impacted equities, highlight the proverbial “canaries in the coal mine” related to North Korea, and discuss rules of thumb about factoring geopolitical risks into portfolio decision-making.

The world's 10 largest militaries by active personnel



Source - RBC Capital Markets, RBC Wealth Management, World Bank, OECD

Historically, equity markets have reacted to military clashes in a more muted manner than one may think.

Tension and release

Historically, equity markets have reacted to military clashes in a more muted manner than one may think.

The S&P 500 fell 6.3%, on average, in 17 post-WWII military conflicts listed in the table below. 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.

But like any small sample size, there were notable deviations. Markets were not immune from volatility and losses. Some events sparked 10%+ corrections and negatively impacted the economy.

For example, the S&P 500 dropped 15% when the U.S. bombed Cambodia during the Vietnam War, and it declined 16% when Iraq invaded Kuwait. The 9/11 terrorist attacks brought about a decline of almost 12%. Each of these events occurred

S&P 500 responses to select acts of war and terrorism since WWII

Events	Start date	# trading days to trough	% change to trough	# trading days back to even
Acts of war				
U.S.				
U-2 spy 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 seized in Iran	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
Nice Bastille Day attacks	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, The National Security Archive at George Washington University, U.S. Naval Institute. Data attempts to capture any pre-event impact.

The lesson seems to be that when military aggression or wars are significant on a geopolitical scale, it does not necessarily mean equity markets will automatically sell off sharply.

during recessions and likely extended or exacerbated the periods of economic weakness.

It may seem surprising the market did not react more sharply to the Cuban Missile Crisis or the Six-Day War Israel faced given their gravity. The lesson seems to be that when military aggression or wars are significant on a geopolitical scale, it does not necessarily mean equity markets will automatically sell off sharply. Numerous circumstances shape market performance at any given time.

In the case of the Cuban Missile Crisis, the S&P 500 had already plunged 26% months ahead of the confrontation. This “flash crash” had far more to do with extremely high equity valuations, the unwinding of market excesses, and trading mechanics than the prevailing geopolitical strains. The drop may have muted the subsequent selloff during the Cuban Missile Crisis.

It goes without saying that local equity markets could be affected more dramatically by military clashes or a major terrorist attack if the civilian population and infrastructure are seriously impacted.

Stress tests

The canaries in the coal mine of any forthcoming stress on the Korean Peninsula would likely be gold, South Korea’s government bond market, and select currencies.

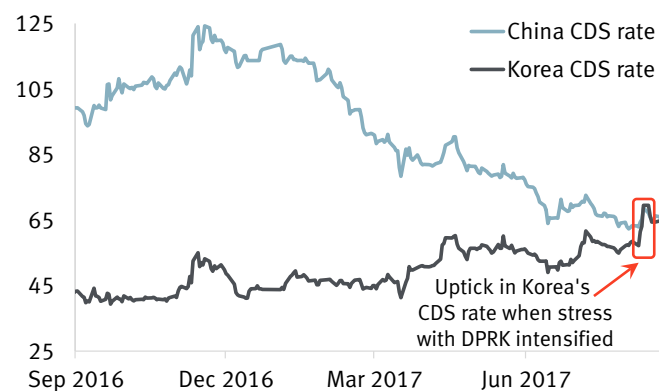
Gold is typically the go-to safe haven when trouble hits. Bullion bounced 5% when North Korea recently tested longer-range missiles and the related rhetoric escalated. If tensions re-emerge gold would likely benefit, but otherwise faces some near-term headwinds (see [page 21](#) for more).

South Korea’s bond market is on guard, as the 10-year government yield now trades at a modest yield premium to the comparable U.S. Treasury yield, erasing a long-standing discount. We think the premium would increase if risks of a military conflict flare up again, as South Korea bond yields would likely rise while Treasury yields could fall (and bond prices would do the opposite).

Credit default swap rates are another important risk measure. The cost of insuring 5-year South Korea government bonds against default jumped 22% in just three

Credit default swap (CDS) rates for 5-year sovereigns

(in USD basis points)



The cost to insure Korean and Chinese bonds against default is now roughly the same.

Source - RBC Wealth Management, Bloomberg; data through 8/25/17

As geopolitical events play out, the market ultimately gauges the potential economic implications.

days when the prospect of a North Korea-U.S. military clash increased. By this indicator, the risk of South Korea sovereigns is now nearly equal to that of Chinese government bonds.

Among currencies, South Korea's won qualifies as an obvious canary. It declined 2.7% against the dollar during the recent wave of stress. In contrast, the Swiss franc and Japanese yen are often viewed as safe havens. They rose against the dollar when the verbal confrontation intensified.

What's your comfort level?

More broadly, the North Korea uncertainties raise a pertinent question for equity investors: How should geopolitical risks be factored into portfolio decisions?

The difficulty in budgeting for geopolitical risks is that they are often unquantifiable and include multiple, complex scenarios that can be outside of the market's ability to recognize or grasp. Geopolitical events can occur unexpectedly, such as the 9/11 terrorist attacks. At other times, global markets may overreact like they did when Iraq invaded Kuwait.

In determining equity allocations, investors would be prudent to assume that significant geopolitical risks can crop up from time to time that could push the equity market into a temporary 5%–10% pullback or even a 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.

As geopolitical events play out, the market ultimately gauges the potential economic implications. Indicators such as consumer and business confidence, retail sales, and manufacturing activity, along with commodity prices, tend to be the arbiters of whether a geopolitical event will have a transitory or longer-term impact on markets and economies.

Maintenance check

The North Korean flare-up is a reminder that it's always the right time for investors to assess whether their equity exposure is appropriate given their full financial profile and if equity allocations are properly calibrated to match one's liquidity needs, risk tolerance, and time horizon, among other factors.

With or without the escalation of concerns around North Korea our recommendation would argue for leaning against risk by scaling back equity allocations, or sector exposures or individual security positions that may have ballooned during the recent rally. The amplified geopolitical risks underscore this message.

Fast track to the future



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Technological innovation can be particularly disruptive to the old guard. By bringing cutting edge and often cheaper products or services, disruptive technologies can force incumbents to transform their business models or processes to regain competitiveness. Share prices of affected companies can suffer severe setbacks. What can investors do?

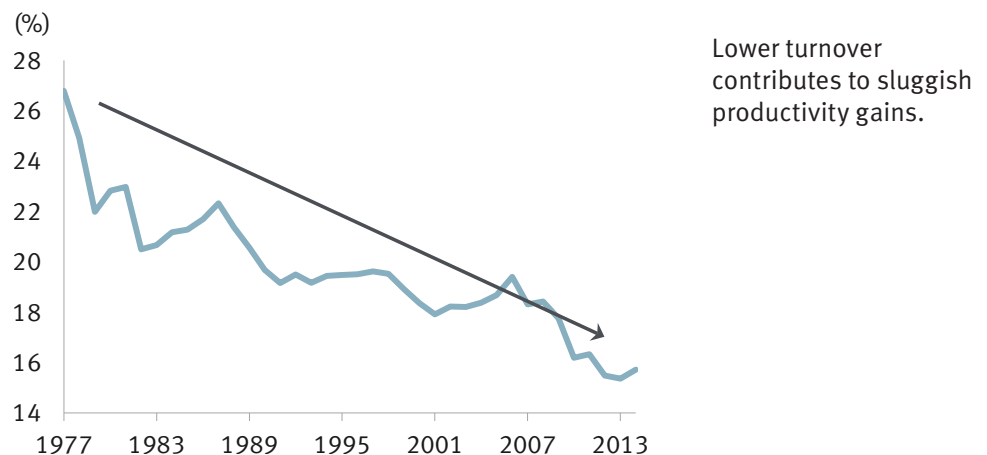
Disruption in perspective

With Uber replacing traditional taxis, Airbnb assailing the hotel industry, and smartphones reconfiguring the market for PCs and digital cameras, not to mention the prospect for self-driving cars as well as computers taking on diagnostic functions in hospitals, is a new world order upon us?

Perhaps, but this impression is at least in part a product of the lack of change and disruption that has characterised the past 40 years in the opinion of Eric Lascelles, chief economist at RBC Global Asset Management.

He points out that from as far back as the 1970s there has been a steady decline in the turnover of U.S. firms. Relatively few new companies have been created and fewer have closed down.

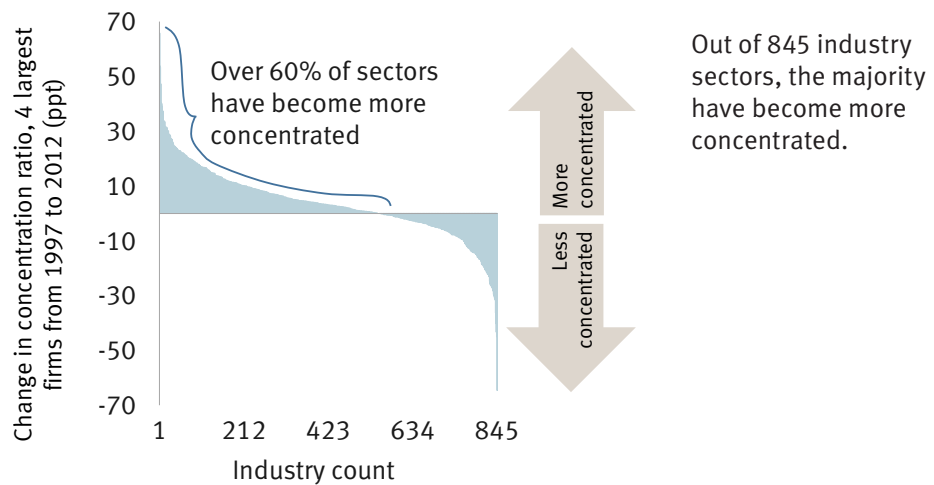
U.S. firm turnover has declined steadily



Note: Measured as number of firms opened or closed in a year as % of total
Source - U.S. Census Bureau, RBC Global Asset Management

Moreover, he observes that fully 60% of all sectors are more concentrated today than they were 10 years ago. Successful companies operating in concentrated industries can become more sluggish and complacent, innovating and disrupting less. This low business dynamism, stemming from low corporate turnover and rising industry concentration, in Lascelles's view, constrains economic activity and arguably is a factor behind the lacklustre growth and sluggish productivity gains of recent years.

U.S. industry concentration has increased



Note: Change in concentration ratio (i.e., revenues of the four largest firms as % of total in a sector)
Source - U.S. Census Bureau, RBC Global Asset Management

So disruption may not yet be as widespread as one might be led to believe, though there are reasons to think that this may be about to change.

The new face of disruption

For those companies impacted by disruption, there is a risk they will underestimate disruptive threats. Think of Jim Keyes, CEO of Blockbuster, who stated in 2008 that “neither RedBox nor Netflix are even on the radar screen in terms of competition.” Blockbuster filed for bankruptcy in 2010.

Disruption will likely accelerate as new services or products are created today, made possible by technologies which require low levels of capital investment. Compare, for example, the modest capital requirements Airbnb initially needed to disrupt the hotel industry with the very costly investments required to build railways which replaced rivers as a means of transport. In fact, the prohibitively hefty investment required was one of the reasons why steam engines arrived on the scene in the 17th century but didn’t come to dominate the industrial landscape until the 19th century.

More modest capital requirements lower the barriers to entry for new disruptors, enhancing competitive dynamics and adding pressures on incumbent companies. It is one of the reasons cited by outgoing General Electric CEO Jeff Immelt at a recent event where he stated that global disruption was “breathtaking” and unstoppable. “None of it is going to get any easier. It’s only going to get harder.”

Sectors at risk

The table on the following page shows disruptive technologies for select vulnerable industries, the potential impact on related business models, and the expected time frame. To put the disruption in context, some key regulatory headwinds are noted. Conceivably, the most affected industries are those which face technological disruption at a time when the regulatory burdens are either particularly heavy or changing as well. Auto, financials, and energy are at the top of the list.

Fast track to the future

The auto industry faces enormous technological challenges with the advent of the electric vehicle (EV) powered by lithium-ion batteries. Adopting this technology opens the door to a complete rethink of fundamental design and production processes. RBC Capital Markets estimates that the number of moving parts in an EV engine is less than 150, down from more than 2,000 in an internal combustion engine. Clean air regulation is spurring this paradigm shift, and France (2030) and the U.K. (2050) have set emission-free deadlines for cars sold. EVs currently reduce carbon emissions by half compared to petrol-powered cars.

If this was not enough, the auto industry is already contending with the rise of the sharing economy, itself enabled by high levels of connectivity. This has already

Disruptive technologies and regulation for key industries

Some vulnerable industries	Key disruptive technologies	What is at risk?	When?	Disruptive regulation	Impact
Auto	Driverless cars	Additional investment, competitive position, sales	5–10 yrs.	Energy efficiency	Capex, supply chain
	Electric cars	Additional investment, competitive position, sales	5–10 yrs.		
	Connectivity & sharing economy	Lower sales volumes	5–10 yrs.		
Capital Goods	3D printing	Supply chain, loss of competitive position	5–10 yrs.	Energy efficiency, Environment	Lower volumes, Higher costs
	Renewable energy	Product suite	Ongoing		
	Energy battery storage	Product suite	10 yrs.		
Energy	Robotics	Capex	5–10 yrs.	Energy efficiency, Environment	Lower volumes, Higher costs
	Renewable energy	Lower sales volumes	10 yrs.		
Financials	Energy storage of renewable sources	Lower gas demand if consumers switch to electric-based heating, drawing on renewable energy battery storage	10 yrs.	Capital adequacy, Other regulations	Lower returns, Higher costs, Lower returns on equity
	Fintech	Lower revenues & margins	Ongoing		
	Crowd funding	Lower revenues & margins	Ongoing		
	Peer-to-peer lending	Lower revenues & margins	Ongoing		
	Robo advisers	Lower revenues & margins	Ongoing		
	Mobile internet	Number of branches, costs	Ongoing		
Health Care	Artificial intelligence	Back-office cuts	Ongoing	← Environment (coal)	Higher costs
	Biosimilars	Pharma's manufacturing process	5 yrs.		
	Medical robots	Capex, training costs	Ongoing		
IT	3D printing	Medtech manufacturing process	10 yrs.	← Minimum wage	Lower margins
	Cloud technology	Lower hardware demand	Ongoing		
Leisure (travel, hotels, restaurants)	Connectivity & sharing economy	Lower revenues & margins	Ongoing	← Minimum coverage	Higher capex
Media	Internet	Business models	Ongoing		
Mining	Advanced materials	Lower steel sales volumes	Ongoing		
Real Estate	eCommerce	Lower retail real estate	Ongoing		
Retail	Mobile internet	Brick-and-mortar retailers	Ongoing		
Telecoms	5G	Higher capex	5 yrs.		

Source - RBC Wealth Management

Disruption in one sector
can ripple through
adjacent sectors.

cut into demand from young adults in large cities, where the average car sits idle for 23 hours each day. Studies by the Organization for Economic Cooperation and Development (OECD) and the Boston Consulting Group suggest the advent of self-driving vehicles would make ride sharing even more pervasive, perhaps accounting for 25% of all miles driven by 2030.

Retail is another industry where business models are facing radical disruption. Amazon has already almost singlehandedly reconfigured much of the industry, and now Wal-Mart is making a massive push. More than 35% of apparel sales are now done online.

Amazon has now trained its crosshairs on the retail food industry, which so far has been largely immune from online disruption, generating a mere 1% in online sales. Its purchase of Whole Foods is a warning shot, and Amazon hopes to use that company's fleet of refrigerated trucks and supply chain managers and embed them into its ecosystem of data and artificial intelligence. If Amazon can be aware, through connectivity and digitisation, of when consumers are running out of a product, it can deliver the item to consumers' doors faster than the competition and with more convenience by eliminating a trip to the store.

If Amazon (and now Wal-Mart) succeeds, the ensuing disruption will not be confined to food retail. Given the rapid penetration of online retailers, large food stores are often the only remaining reason why buyers continue to visit shopping centres. Retail rents are under pressure, which may lead to credit impairments for lenders. Industry observers look for retail space closures in the U.S. this year to comfortably exceed those of the 2008 financial crisis year. This could entail collateral damage not only for the broader commercial real estate market but also potentially on residential land prices. The U.S. would be most affected given retail space ranges between 20–25 square feet per person, compared to some 15 square feet in Canada, and 2–5 square feet in Europe, according to Morningstar and RBC Capital Markets.

Protecting portfolios

Once the possible threats to an industry have been ascertained, the second step to protect portfolio values would be to identify those companies which can adapt and survive, and those which will struggle. This is key as in 1935 the lifespan of an S&P 500 company was 90 years, though it has dropped to 18 years today, according to a McKinsey & Company study.

Determining which leopard can change its spots is no easy task. The impact of a disruptive technology may not be visible immediately and may easily be misjudged. For example, the food industry was not immediately revolutionised with the advent of the tin can in the early 1800s. That awaited the invention of the can opener half a century later.

Assessing whether companies have a good track record at generating high returns will not be sufficient, nor will being a proven innovator. All too often, a company's power and willingness to adopt new technologies is limited by the burden of legacy businesses that management feels the need to protect.

The focus needs to be on management's ability and willingness to consider doing things completely differently, and to even allow some core divisions and "sacred

“cows” to die off. A management team which has led a company to an established, successful position may not be best-placed to lead it through times when it may need to reinvent itself.

Companies which rely too much on what is currently popular with customers or are too eager to protect their margins tend to ignore new technological trends, according to a recent study from the Harvard Business School. They see their own success as evidence their customers are happy with what they are offering today. Potential costs of adopting new technologies may also be judged unnecessary and unhelpful to meet profit targets. But when a competitor brings innovative technology to the market, and starts to encroach on market share, the competitive gap may be already too wide to bridge.

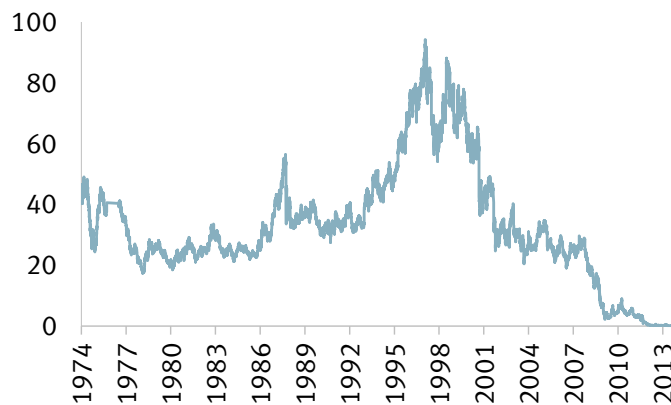
A tale of two tech giants:
Kodak’s and Canon’s
diverging fates.

The stark difference in the fates of Kodak and Canon in facing the competition of digital cameras and mobile phones is a case in point.

Kodak had a culture of “perfection,” which enabled it to enjoy an 85% share of camera sales in the late 1970s. But with this dominant market position came a complacency which prevented a “first to market” attitude. Its response to the threat of digital photography and mobile phones was late. And none of its eventual responses were enough to turn the tide. The company was delisted from the NYSE in 2012, went through a painful bankruptcy in which it sold off most of its valuable patents, and re-emerged as a much smaller and dramatically less valuable company.

Kodak goes belly up

Kodak share price (USD)



Kodak’s response to digitisation was not radical enough ...

Source - Bloomberg, RBC Wealth Management; data through 9/3/13

Canon faced similar threats. While it suffered a 37% decline in digital camera sales in the 10 years to 2016, it has moved away from mass market compact digital cameras and now targets the high-end hobbyist and professional market. It is aggressively pursuing its innovation effort, developing a whole slate of new products, including virtual reality design studios, 3D printing materials, surveillance cameras, and medical imaging. It is a powerful force in the printer industry. While the stock has largely moved sideways for the last 10 years, it has escaped Kodak’s fate.

Canon does better

Canon share price (JPY)



... Canon responded more forcefully.

Source - Bloomberg, RBC Wealth Management; data through 8/22/17

Opportunity

Disruption also can bring opportunity. Manufacturing companies which adopt 3D printing processes and make wise use of automation and robotics may well see margins expand after their initial investment. Businesses that use artificial intelligence to optimise their supply chain may improve cash flow. And the developers of new technologies that prove to be truly disruptive by changing an established industry or creating a new one will be aggressively sought out by investors.

Evaluating whether an established business is prepared and capable to adopt and exploit new technologies is not necessarily easy, but it is within the normal purview of investment analysis. However, picking from among the many firms working to become the next big disruptor, of which only a handful will succeed, has much more of speculation than investment about it.

Even successful new innovators can travel a bumpy road. Nvidia makes 3D graphics processors which transform PCs into gaming devices. The share price lost some 80% not once but twice between 2002 and 2008 before appreciating by more than 2,900% over the past eight years.

To the future and beyond

The pace of disruption looks poised to accelerate, with wide-ranging implications for any portfolio. We advocate the best defence for investors continues to be avoiding industries which face too many disruptive headwinds and reiterate the importance of investing in the highest-quality companies, with agile, responsive management, open to new ways of competing and prepared to transform and, if necessary, sacrifice legacy businesses to remain competitive and dominant.

Diversification is always the first line of defence for the prudent investor and is also the best way to incorporate higher-risk positions in a portfolio. Boards and management teams may face very difficult and often painful decisions when confronted by disruptive competition in their industry. Investors can be much more dispassionate when determining whether to stay or go.

Wise use of disruptive technologies can increase margins or improve cash flow ...

Sound track

The economics team at RBC Global Asset Management looks at 17 measures of the U.S. economy and financial markets that, taken together, can give a reliable indication of where the economy is in the business cycle. The data comes down in favor of the economy being in the late cycle phase. That's not too surprising as most observers are in that camp. What is surprising is that it's a reasonably close call between late cycle and mid-cycle. Chief Economist Eric Lascelles concludes that "there is a chance the next [U.S.] recession is a bit more distant than previously imagined."

Most developed economies, certainly the U.S., Canada, Europe, and Japan, are running at a growth pace that is at or above their long-term potential. Activity indexes and new orders all point to further growth in the coming months and quarters, as do reliable leading indicators.

Corporate revenues and earnings are growing faster than the economies those companies live in. And the guidance offered by management about the prospects for the coming quarters suggests this very good profit picture

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Equity views

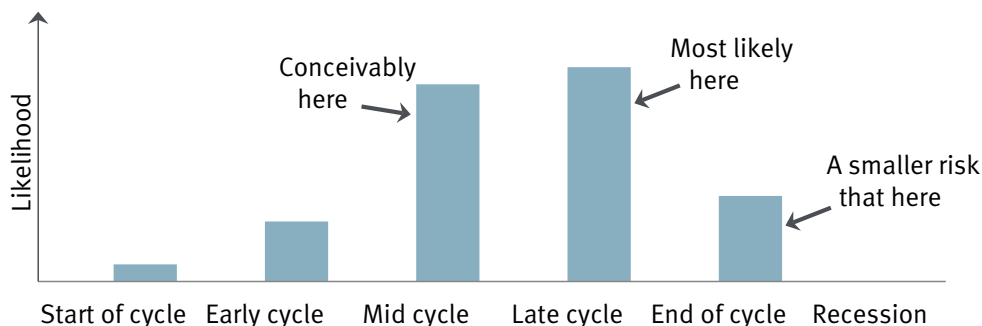
Region	Current
Global	+
United States	=
Canada	=
Continental Europe	+
United Kingdom	-
Asia (ex-Japan)	=
Japan	=

+ Overweight = Market Weight - Underweight
Source - RBC Wealth Management

will prevail into next year. So, while price-to-earnings multiples are higher than they were a year ago, the growth prospects comfortably support those more elevated valuations.

We expect that, eventually, adverse changes in credit conditions will build to a level that produces an economic downturn. And it's true that most major central banks have turned an important corner and are now headed toward "normalising" monetary conditions. It's also true that no central banker is interested in snuffing out the better GDP growth rates that have emerged. Given that inflation readings remain extremely benign, they are under

U.S. economy most probably in late cycle



Note: Calculated via Scorecard technique by RBC Global Asset Management
Source - RBC Global Asset Management

no pressure to do so. They have all indicated that the path toward normal conditions will be a gradual one.

In the case of the U.S., it has typically taken a “real” federal funds rate (i.e., the effective fed funds rate minus the rate of price inflation) that was higher than the growth rate of the economy before a recession was imminent.

Today inflation is running at 1.5% and the effective fed funds rate is just 1.15%, making the “real” fed funds rate minus 0.35%. Meanwhile, the year-over-year growth in GDP stands at 2.1%. So, if nothing else changes, the fed funds rate will have to rise by another 2.5 percentage points before the economic outlook would pose a serious risk to equities.

As it stands, we think the earliest Fed rate hiking could bring us to that juncture would be well into 2019. And, of course, all things won't remain equal. The kind of things that would provoke a central bank into raising rates more aggressively would be a pickup in growth that produced an unwanted flare-up in inflation. All of which would likely require an even higher rate than laid out above.

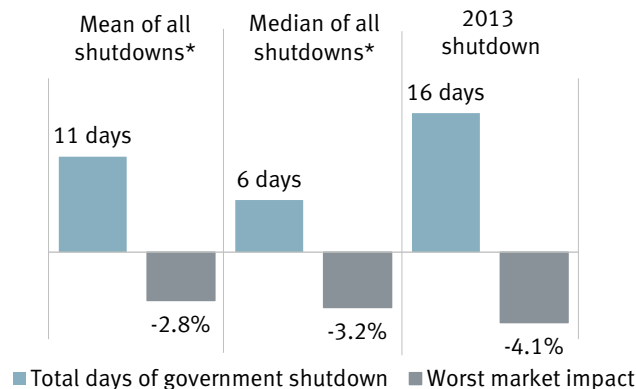
Despite more demanding valuations we are comfortable with our moderate Overweight recommendation for global equity portfolios. In particular, we point to our Overweight commitment to Europe where we can find attractive, quality businesses trading more cheaply and offering a better growth outlook than their counterparts elsewhere.

Regional highlights

United States

- Our long-term outlook for the U.S. equity market remains positive, but we are circumspect about the near term given the duration and strength of the recent rally, the potential for noisy fiscal debates in Washington, and elevated valuations.
- Congress and the president need to authorize temporary or longer-term government funding by September 30. If they don't, the government will “shut down” (lapse in some, but not all services). This occurred 17 times from 1976 to 1996 and again in 2013. This go-around, the issue may hinge on funding for the president's border wall. When the government shut down for 16 days in 2013, the S&P 500 pulled back 4% and resumed its

Impact of government shutdowns on the S&P 500 since 1976



When the government shuts down, there is often a short-term market pullback.

* Data includes time periods called “funding gaps,” which existed before the nomenclature of “shutdown” became widely accepted
 Source - RBC Wealth Management, Bloomberg, The Washington Post, Congressional Research Service, and the University of California at Berkeley

upward trend once the episode blew over. Government shutdowns can prompt a temporary pullback in the market, but should not have a lasting impact.

- The debt ceiling is the more important issue for financial markets, the banking system, taxpayers, and the credit worthiness of the country. It must be raised around September 29 or soon thereafter (date uncertain) so the government can meet its financial obligations. We believe there is a high probability the debt ceiling will be raised in a timely manner. After all, banking and Wall Street veterans hold senior posts in the administration, including Treasury Secretary Steven Mnuchin and Chief Economic Advisor Gary Cohn.

Canada

- Our Market Weight view for Canadian equities reflects a balanced risk-reward assessment for key sectors. Bank valuations are reasonable in a historical context and leave some room for modest multiple expansion in the event investors become comfortable with a “cooling” but not “correcting” Southern Ontario housing market. Energy valuations appear substantially discounted but reflect what we see as a cautious medium-term outlook for commodity prices.
- Q3 reporting from the Canadian banks featured resilience in credit metrics with loan loss provisions near cyclical lows. Strong economic growth and low unemployment have provided fundamental support for loan books. We are incrementally more constructive on bank stocks as we believe the narrative around

the housing market could shift from severe correction concerns to a relatively more benign loan growth headwind.

- The first round of North American Free Trade Agreement (NAFTA) negotiations kicked off last month with RBC Economics providing a range of outcomes for Canada under a renegotiated framework. In a best-case scenario, Canada could benefit from an easing in non-tariff barriers and regulatory “red tape.” The worst-case scenario would see the U.S. unilaterally withdraw from NAFTA and impose tariffs that RBC Economics estimates could reduce Canadian GDP by around 1% over the next 5 to 10 years.

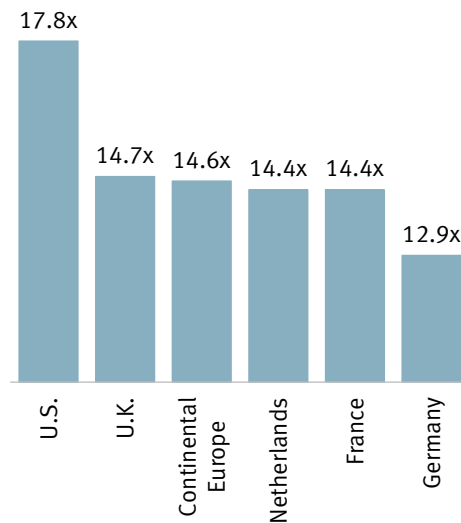
Continental Europe & U.K.

- We are Underweight U.K. equities. After a brief summer hiatus, Brexit negotiations are resuming. The focus is on EU citizens’ rights in the post-Brexit U.K., the border between Europe’s Ireland and the U.K.’s Northern Ireland, and the financial settlement to be paid by the U.K., also known as the “divorce bill.” With the EU insisting these issues be resolved before the terms of the new trade relationship can be discussed, it is not clear that both parties will be able to agree to the desired smooth transition before the March 2019 deadline. This uncertainty should keep U.K. interest rate expectations anchored and the pound weak. As such, we continue to prefer exporters.
- We maintain an Overweight position in European equities. Economic momentum is healthy, corporate earnings are robust, and relative valuations are undemanding. We

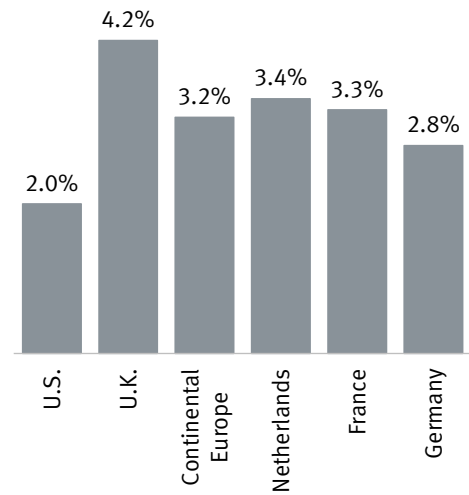
Europe remains less expensive than the U.S. and demonstrates greater yields despite the improving economic backdrop on the continent.

Valuations and dividend yields

Forward P/E ratios



Dividend yield



Source - RBC Wealth Management, Bloomberg; data through 8/30/17

are not overly concerned yet by the recent strength of the euro. While some exporters may suffer, importers of raw materials should benefit, offering some relief. This benign state may well get tested as political risk reasserts itself with both the reform efforts in France coming to a head this autumn and Italian elections in Q1 2018. That said, the region seems better placed now to withstand these uncertainties.

Asia

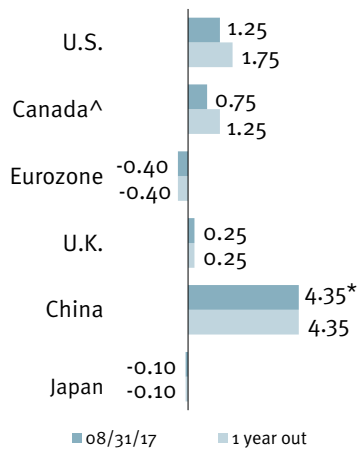
- Asian equities consolidated in August after a strong performance this year. The MSCI AC Asia Pacific Index held up well even as geopolitical tensions between the U.S. and North Korea escalated.
- China's economic activity softened in July due to more moderate export growth and a housing slowdown. Industrial output, fixed-asset investment, and retail sales also grew at a slower pace, and all missed expectations. After reaccelerating

in the first half this year, China's economic growth is likely to moderate in the second half mainly driven by slower housing activity. We anticipate policymakers will continue to enforce regulatory tightening to rein in excess leverage.

- We are Market Weight for Greater China stocks. Earnings growth has been strong this year, but may moderate with the economy. Valuations, especially for A-shares, are not attractive. On the other hand, the government would prefer reduced market volatility during the current period of financial deleveraging and heading into the 19th National Congress this autumn.
- We remain constructive on Japanese equities. Japan posted 4% annualized GDP growth in Q2, the highest uptick since Q1 2015. Exports and imports accelerated in July, showing external and domestic demand is recovering. The unemployment rate remained at the lowest level in the past 20 years.

Bubble, bubble, toil, & trouble

Central bank rate (%)



^under review
*1-yr base lending rate for working capital, PBoC
Source - RBC Investment Strategy Committee, RBC Capital Markets, Global Portfolio Advisory Committee, Consensus Economics

Paraphrasing William Shakespeare’s *Macbeth* for our title, we note that former Federal Reserve Chair Alan Greenspan recently warned of a bond bubble. He further suggested the bubble is on the cusp of bursting due to abnormally low interest rates and that the collapse poses a threat to financial markets. The comments caused a stir, but, in our opinion, investors shouldn’t expect dire near-term consequences in his warning, for which he has “no time frame”; we believe concerns over abnormally low interest rates and a bond bubble are misplaced.

Are rates “abnormally low,” or is this the new normal? We think the latter, even as some central banks begin to signal adjustments to current stimulus efforts. We expect the European Central Bank and Federal Reserve meetings this month to produce outlines for the start to tapering securities purchases, but the early communication efforts should limit market disruptions. Furthermore, since slow growth and low inflation are cross-border commonalities, central banks will remain patient, which to us all but ensures that current interest rate levels will remain the norm rather than an abnormality.

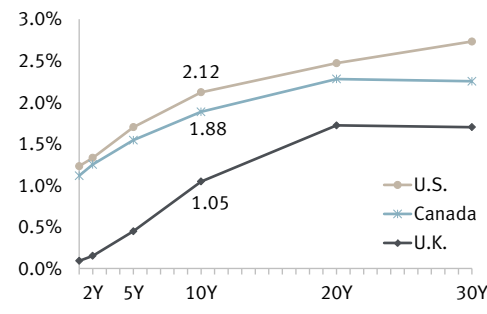
Stretched valuations rather than a “bond bubble” pose the greatest challenges for investors; our regional experts for some months now have noted these conditions. This is not to suggest there aren’t any opportunities in credit, just that investors need to exercise patience and selectivity. What’s more, we believe the current

Fixed income views

Region	Gov’t Bonds	Corp. Credit	Duration
Global	–	+	5–7 yr
United States	–	+	5–7 yr
Canada	–	=	3–5 yr
Continental Europe	=	+	5–7 yr
United Kingdom	–	=	5–7 yr

+ Overweight = Market Weight – Underweight
Source - RBC Wealth Management

Sovereign yield curves



Source - Bloomberg

low volatility environment is providing a perfect opportunity for investors to de-risk and diversify portfolios.

Regional highlights

United States

- The Fed looks to be on the cusp of embarking on the third phase of its withdrawal of monetary policy stimulus at this month’s meeting. Following the end of asset purchases in 2014 and the first rate hike in 2015, the next step will be to begin winding down the balance sheet. We expect the formal announcement of a plan to taper monthly reinvestments, but for it to have minimal market impact.

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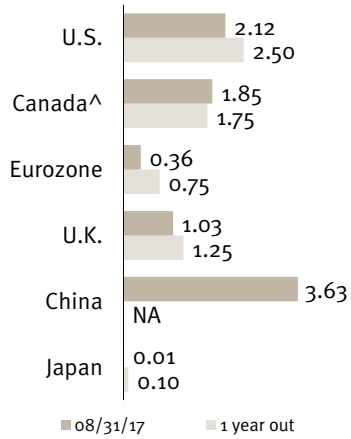
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Global fixed income

10-year rate (%)



^ under review

* Eurozone utilizes German Bunds
Source - RBC Investment Strategy Committee, RBC Capital Markets, Global Portfolio Advisory Committee

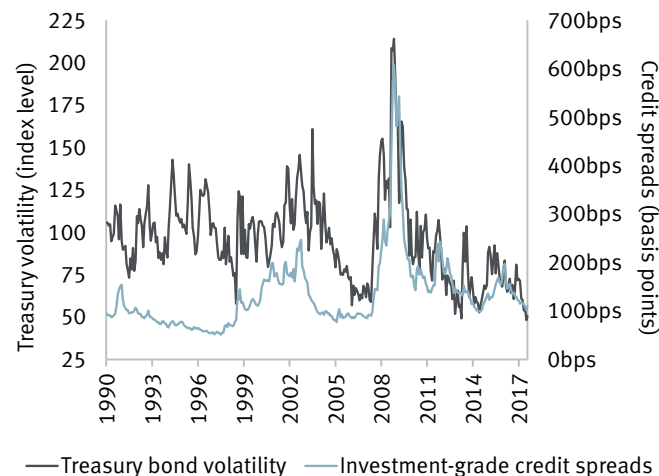
The bigger story will likely be the Fed's quarterly update of economic projections where we expect a lower inflation outlook. This will likely be matched by a decline in rate hike expectations, as the market is already losing faith that there is a need for another increase this year.

- A spike in equity market volatility in August drove selling pressure in the high-yield credit markets—along with significant fund outflows. Despite the selloff and credit spreads reaching their widest levels over Treasuries since April, we are content to stick with our Underweight recommendation on the sector. We like interest rate risk over credit risk, so investors should focus on investment-grade corporates while adding incremental yield via preferred shares, reallocating to riskier assets should better entry points present themselves.
- Strong investor demand coupled with lower-than-expected issuance has contributed to the strength of the muni market through the first half of 2017. We still see the most value beyond 15 years on the muni curve.

Canada

- The Government of Canada yield curve flattened in August as a flight to safety pressured longer bond yields lower. Domestic data points toward another solid quarter of economic growth, although a lack of core inflation provides a limiting factor to reaching materially higher yields.
- We expect the Bank of Canada will be challenged to raise interest rates too quickly due to record-high consumer debt levels and the economy's heavy reliance on the real estate market. Putting this all together, we are comfortable taking on interest rate risk and are focused on short-to-intermediate maturities given the drop in yields further along the curve.
- Credit spreads hovering around their tightest levels in three years keep us slightly cautious about corporate bonds. We continue to recommend investors consider upgrading quality within portfolios, possibly looking at the ever-growing Maple bond comprised of international issuers in Canadian dollars.

Volatility & credit spreads near cycle lows



Current low levels of volatility provide opportunity to de-risk and diversify portfolios.

Source - RBC Wealth Management, Bloomberg; data through 8/25/17

- The preferred share market moved lower over the month. This reflects the flatter curve and the heavy skew toward preferred shares whose cash flows are linked to intermediate bond yields. We continue to think a diversified strategy works best in today's environment.

Continental Europe & U.K.

- The European economy continues to be strong in spite of the headwind posed by the strength of the euro. With core inflation remaining subdued, we believe the ECB's loose monetary stance should be maintained. However, we expect the ECB to announce a tapering of its bond-purchase programme, though the continued reinvestment of maturing bonds should keep prices supported.
- The landscape for European corporate bonds is still benign with the economy at a relatively early stage of its credit cycle. Moreover, we expect Germany's September election to result in a Christian Democratic Union-led coalition, providing continuity.
- However, the strong performance of the asset class this year has removed many opportunities and broad-based valuations are now stretched. We see selective pockets of opportunity in peripheral European debt and bonds that have not been eligible for the ECB purchase programme, particularly in the 5- to 7-year maturities universe.
- With the spike in U.K. inflation arising from the sudden sterling devaluation after the Brexit vote, now largely passed, we expect U.K. interest rates will remain flat for the foreseeable future. This, in itself, is not a bearish indicator, but poor absolute compensation for an economy that is expected to be progressively slowing, with weak wage growth and tighter lending conditions, leaves us bearish on the U.K. Gilt market. We see better opportunities elsewhere. In the sterling market, we prefer 5- to 7-year bonds from issuers that have internationally diversified revenue streams and are to some degree isolated from volatility derived from Brexit negotiations.

Gold at a crossroad

Commodity forecasts

	2017E	2018E
Oil (WTI \$/bbl)	48.47	50.00
Natural Gas (\$/mmBtu)	3.01	3.00
Gold (\$/oz)	1,269	1,300
Copper (\$/lb)	2.60	2.75
Corn (\$/bu)	3.75	4.00
Wheat (\$/bu)	4.60	4.90

Source - RBC Capital Markets forecasts (oil, natural gas, gold, and copper), Bloomberg consensus forecasts (corn and wheat)

After a 14% rally year to date, we believe investors should soften their expectations for further significant gains for spot gold prices in the near term. Some of the positive macro tailwinds that have been supportive of bullion could fade in the months ahead. Beyond the short term, the steep decline in global mineable reserves could prove to be an underappreciated bullish catalyst for gold in the years ahead.

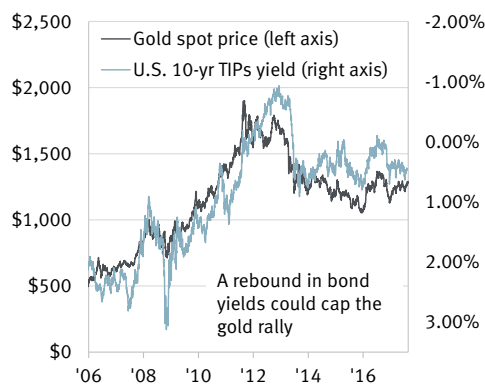
Bond yields and the U.S. dollar are key factors that can influence the direction of gold prices (see lower left chart). Lacklustre U.S. economic data in the first half of 2017 drove bond yields and the greenback lower, helping to fuel a rally in gold. As economic forecasts have adjusted lower, and most leading indicators continue to paint an upbeat outlook for the U.S. economy, we believe there is now meaningful scope for data to surprise to the upside heading into Q4, especially if the U.S. economy follows its recent pattern of regaining momentum in the latter half of the year. The upshot is that near-term risks for bond yields and the dollar are modestly biased to the upside, which may constrain the gold rally.

A hefty dose of geopolitical anxiety (e.g., Korean Peninsula) has also boosted

gold prices as investors sought refuge. Holdings of gold-backed exchange-traded funds rose by 167.9 tons in the first half of 2017 to 2,313 tons as of June, the highest level since last October, according to the World Gold Council. Geopolitical tensions, while ever-present, are difficult to predict and tend to be fleeting in nature. But if history is any guide, investors should anticipate some of the geopolitical concerns currently embedded in gold prices to unwind if the headline shocks subside.

Longer term, given a backdrop of dwindling reserves, the potential for mine production to start falling over the coming years could turn into a more fundamental driver of gold prices. The protracted 45% correction in gold prices between 2011–15 forced gold miners into balance-sheet preservation mode. A chronic lack of investment during the bear market has resulted in a sharp drop in new deposit discoveries and, by extension, considerable reserve exhaustion at operating mines. As gold miners' average reserve life has fallen to just over 10 years in 2016 from a peak of 16 years in 2010 (see lower right chart), global mine output could peak in the next few years, eventually putting upward pressure on gold prices.

Neutral near-term outlook but reserves depletion could bolster gold prices long term



Source - Bloomberg, RBC Wealth Management

Source - Company reports, RBC Capital Markets' estimates

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Currency forecasts

Currency pair	Current rate	Forecast Sep 2018	Change*
Major currencies			
USD Index	92.66	98.44	6%
CAD/USD	0.80	0.78	-2%
USD/CAD	1.24	1.28	3%
EUR/USD	1.19	1.08	-9%
GBP/USD	1.29	1.24	-4%
USD/CHF	0.95	1.08	14%
USD/JPY	109.98	104.00	-5%
AUD/USD	0.79	0.73	-8%
NZD/USD	0.75	0.69	-8%
EUR/JPY	130.98	112.00	-14%
EUR/GBP	0.92	0.87	-5%
EUR/CHF	1.14	1.17	3%
Emerging currencies			
USD/CNY	6.59	7.60	15%
USD/INR	63.90	66.80	5%
USD/SGD	1.35	1.45	7%

* Defined as the implied appreciation or depreciation of the first currency in the pair quote.

Examples of how to interpret data found in the Market Scorecard.

Source - RBC Capital Markets, Bloomberg

U.S. dollar: Needs the Fed

While our positive outlook for the dollar has been at odds with performance in 2017, we hold that the dollar can recoup some of those losses before the end of the year. Given the USD's drop in valuation, continued strength in the U.S. labor market, and low expectations for further rate hikes from the Federal Reserve, the majority of dollar weakness could be behind us. Positioning is also no longer as extended and should act as less of a barrier to future gains.

Euro: Ahead of itself

In the short term, we are expecting the euro to give up some of its recent gains, as speculative positioning and overly ambitious expectations for the timeline of normalization of monetary policy from the ECB have carried the single currency too high. Longer term, we are more constructive, as the improved economic position within Europe can support the currency.

British pound: Uncertainty weighs

Inflation in the U.K. continues to outstrip wage growth, eroding the buying power of consumers. This is exacerbated by a limited capacity to borrow further given very low levels of savings. Negotiations between the U.K. and EU have also started with difficulty,

and, in our view, the risks are still skewed much further toward the U.K., and toward further sterling weakness.

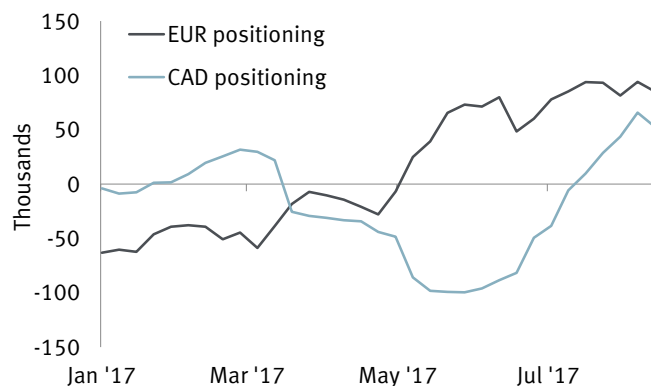
Canadian dollar: Rates argue higher

Given how sharply positioning shifted from net short to long, we would anticipate some weakness in CAD in the near term. Longer term, the currency still remains cheap compared to the historical average, and if the economy continues to grow in line with the Bank of Canada's forecasts, further strength could be warranted. We remain closer to neutral for now, but see opportunity for an upgrade in the medium term.

Japanese yen: Stronger for now

Japanese investors' appetite for foreign investments has been building over the past few months. While interest rates in Japan offer cheap hedging of overseas investments, if the momentum for foreign investment from Japan continues, it is reasonable to suggest some of the outflows will not be hedged, and would result in yen weakness. We continue to target an unwinding of speculative positioning to allow the yen to rally to 100 yen per USD by early 2018, but are monitoring investment flows closely.

EUR and CAD long positioning becoming overextended



Rapid changes in positioning suggest short-term weakness for the euro and Canadian dollar is likely.

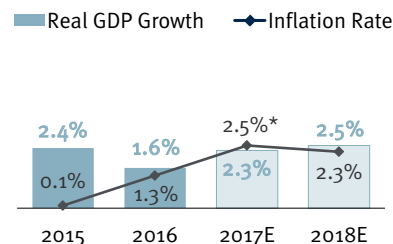
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Source - Commodities Futures Trading Commission, Bloomberg, RBC Wealth Management; data through 8/15/17

*Forecast is under review

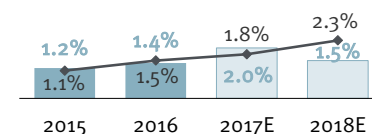
United States — Back to business

- Q2 GDP revised higher to 3% q/q (annualized) reaccelerating from 1.4% in Q1. Inflation data plateauing at sub-2%. Import prices stalled despite weaker dollar, mostly due to lower oil prices. Hiring remained robust, unemployment rate back to 4.3%. Regional Fed manufacturing surveys improving. Over 6.1 million open jobs. Home sales remained muted amid low supply issues, pushing prices higher.



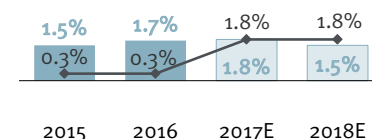
Canada — Consumer-led growth

- Q2 GDP expected at 3.7% q/q (annualized), matching Q1 pace, fueled by consumer spending growth. Retail sales up 0.7% m/m in June. Above-trend growth giving Bank of Canada green light to hike rates in October. Housing construction resilient despite drop in Greater Toronto Area existing-home sales. Hiring strong. Unemployment down to 6.3%. Headline inflation up to 1.2% y/y, from 1.1% y/y prior.



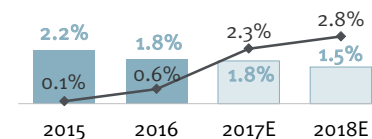
Eurozone — ECB remains cautious

- Consumers driving growth, retail sales up 3.1% y/y; Q2 GDP estimate up to 2.1% y/y. Inflation data stabilizing. European Central Bank remains cautious about removing accommodation without material reacceleration of inflation. Industrial production data suggesting a peak pace of expansion. Employment picture remains unchanged, no suggestions of wage growth.



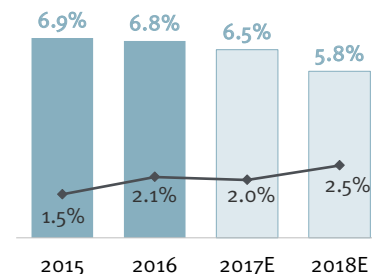
United Kingdom — Forecasts lowered

- Bank of England voted to hold rates steady, and lowered 2018 and 2019 GDP growth forecasts. 3-month retail sales growth dipped to 1.8% y/y, the slowest pace since 2013 as consumers respond to falling real wages. Manufacturing production came in flat m/m. Output has yet to increase in 2017 as Brexit uncertainty outweighs benefits to export demand from weaker pound.



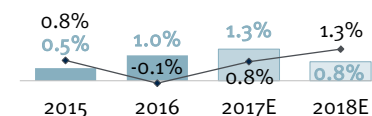
China — The pace slows

- Growth moderated after strong finish to first half of 2017. Retail sales growth slowed from 11% y/y to 10.4% y/y, and industrial output dropped from 7.6% y/y to 6.4% y/y. Hot weather and floods may have weighed on output. The People's Bank of China has continued to hold 7-day repo rate below 3%, but new credit issuance as a percentage of GDP has fallen near a 2-year low.



Japan — Signs of progress

- Q2 GDP rose 4% q/q (annualized), the fastest since 2015. Consumer spending rose 0.9% q/q and business investment 2.4% q/q on strong corporate earnings. Core inflation rose 0.4% y/y, up from -0.6% y/y to start the year. A tight labor market drove real disposable income up 2.1% y/y. Though labor force participation increased, a shrinking working age population should help drive wages and inflation higher.



Source - RBC Investment Strategy Committee, RBC Capital Markets, Global Portfolio Advisory Committee

Market scorecard

Index (local currency)	Level	1 month	YTD	12 month
S&P 500	2,471.65	0.1%	10.4%	13.9%
Dow Industrials (DJIA)	21,948.10	0.3%	11.1%	19.3%
NASDAQ	6,428.66	1.3%	19.4%	23.3%
Russell 2000	1,405.28	-1.4%	3.5%	13.3%
S&P/TSX Comp	15,211.87	0.4%	-0.5%	4.2%
FTSE All-Share	4,072.98	0.7%	5.2%	10.2%
STOXX Europe 600	373.88	-1.1%	3.4%	8.8%
EURO STOXX 50	3,421.47	-0.8%	4.0%	13.2%
Hang Seng	27,970.30	2.4%	27.1%	21.7%
Shanghai Comp	3,360.81	2.7%	8.3%	8.9%
Nikkei 225	19,646.24	-1.4%	2.8%	16.3%
India Sensex	31,730.49	-2.4%	19.2%	11.5%
Singapore Straits Times	3,277.26	-1.6%	13.8%	16.2%
Brazil Ibovespa	70,835.05	7.5%	17.6%	22.3%
Mexican Bolsa IPC	51,210.48	0.4%	12.2%	7.7%
Bond yields	7/31/17	6/30/17	7/29/16	12 mo chg
US 2-Yr Tsy	1.326%	1.349%	0.805%	0.52%
US 10-Yr Tsy	2.117%	2.294%	1.580%	0.54%
Canada 2-Yr	1.275%	1.316%	0.576%	0.70%
Canada 10-Yr	1.849%	2.057%	1.024%	0.83%
UK 2-Yr	0.176%	0.269%	0.144%	0.03%
UK 10-Yr	1.034%	1.230%	0.642%	0.39%
Germany 2-Yr	-0.727%	-0.680%	-0.618%	-0.11%
Germany 10-Yr	0.361%	0.543%	-0.065%	0.43%
Commodities (USD)	Price	1 month	YTD	12 month
Gold (spot \$/oz)	1,321.40	4.1%	14.7%	0.9%
Silver (spot \$/oz)	17.59	4.6%	10.5%	-5.7%
Copper (\$/metric ton)	6,759.50	6.7%	22.4%	46.8%
Uranium (\$/lb)	20.13	0.2%	-1.2%	-20.3%
Oil (WTI spot/bbl)	47.23	-5.9%	-12.1%	5.7%
Oil (Brent spot/bbl)	52.38	-0.5%	-7.8%	11.4%
Natural Gas (\$/mmBtu)	3.04	8.8%	-18.4%	5.3%
Agriculture Index	279.98	-5.0%	-3.8%	0.3%
Currencies	Rate	1 month	YTD	12 month
US Dollar Index	92.6680	-0.2%	-9.3%	-3.5%
CAD/USD	0.8011	0.0%	7.7%	5.0%
USD/CAD	1.2482	0.0%	-7.1%	-4.8%
EUR/USD	1.1910	0.6%	13.2%	6.7%
GBP/USD	1.2930	-2.2%	4.8%	-1.6%
AUD/USD	0.7947	-0.7%	10.3%	5.7%
USD/JPY	109.9800	-0.3%	-6.0%	6.3%
EUR/JPY	130.9800	0.3%	6.5%	13.5%
EUR/GBP	0.9211	2.8%	7.9%	8.5%
EUR/CHF	1.1418	-0.3%	6.5%	4.0%
USD/SGD	1.3559	0.0%	-6.3%	-0.5%
USD/CNY	6.5901	-2.0%	-5.1%	-1.3%
USD/MXN	17.8863	0.5%	-13.7%	-4.8%
USD/BRL	3.1491	0.7%	-3.1%	-2.4%

The EURO STOXX 50 dipped below its 200-day moving average as euro strength is expected to weigh on corporate earnings.

Yields fell in the U.K. as inflation slowed and the BoE lowered its GDP growth forecasts.

Gold rallied on haven demand stemming from heightened geopolitical uncertainty.

Rising euro strength looks to be a headwind for the ECB's inflation target.

Equity returns do not include dividends, except for the German DAX and Brazilian Ibovespa. Equity performance and bond yields in local currencies. U.S. 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. Examples of how to interpret currency data: CAD/USD 0.80 means 1 Canadian dollar will buy 0.80 U.S. dollar. CAD/USD 5.0% return means the Canadian dollar has risen 5.0% vs. the U.S. dollar during the past 12 months. USD/JPY 109.98 means 1 U.S. dollar will buy 109.98 yen. USD/JPY 6.3% return means the U.S. dollar has risen 6.3% vs. the yen during the past 12 months.

Source - RBC Wealth Management, RBC Capital Markets, Bloomberg; data through 8/31/17.

Research resources

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