


Global Insight

Perspectives from the Global Portfolio Advisory Committee

A less taxing situation

Sweeping tax relief will reshape the U.S. corporate environment, boosting prospects for earnings, the economy, and shareholders.


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Wealth Management

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The biggest overhaul of the U.S. tax code in a generation will touch all corners of the U.S. economy—none more so than U.S. businesses. Slashing the corporate tax rate will feed a surge in earnings that should enable companies to grow and prosper and, in turn, provide investors with a variety of benefits.

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2018 brings an appealing, in sync setup for global equities. The world's major economies are growing sustainably, credit conditions remain accommodative, and corporate profits are climbing. While there will be volatility along the way, we are comfortable with our moderate Overweight stance.

17 Global fixed income: A few of our favorite things

As the “green shoots” materialize in most major global economies, there are several storylines investors should pay attention to as global central banks look to normalize monetary policy: developing momentum for GDP growth, ongoing tame inflation, and further yield curve flattening.

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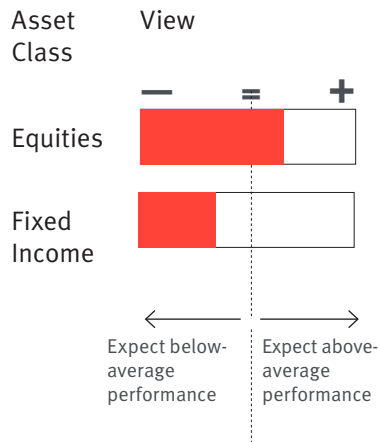
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All values in U.S. dollars and priced as of market close, December 29, 2017, unless otherwise stated.

RBC's investment stance

Global asset views



See “Views explanation” below for details

Source - RBC Wealth Management

Equities

- With a further uptick in December, global equities returned handsome gains in 2017. We expect 2018 to be another rewarding year, but it would be asking a lot for the path to be as “wobble-free” as the year just past was for most major markets. Setbacks cannot be ruled out.
- Corporate earnings remain robust in most regions, and consensus expectations are being upgraded in Japan and the U.S., thanks to better growth prospects and tax reform, respectively. Valuations, though less attractive than they have been, could extend further in some regions, with mainland Chinese stocks being a significant exception. We suggest investors continue to hold a modest Overweight position in global equities.

Fixed Income

- The U.S. yield curve flattening continued to be a topic of focus as the 10-year Treasury yield closed the year much where it had started, while short-term rates have been propped up by expectations of Fed rate hikes in 2018. Avoiding an outright inversion of the curve, often a precursor of recessions in past cycles, should limit the Fed to two rate hikes in 2018 versus the three currently expected by the market, in our view.
- Elsewhere, while economies are growing, inflation remains subdued in most cases, and we expect central banks to merely reduce accommodation (Europe), or keep rates on hold (Canada, the U.K.).
- Nevertheless, with valuations less attractive, we prefer to maintain our Underweight stance in this asset class.

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.

A less taxing situation



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The landmark U.S. tax reform bill, with massive corporate tax relief as its centerpiece, should add fuel to the U.S. economic growth engine. And with corporate earnings poised to meaningfully jump, U.S. equities should have a firm backbone of support. While some concerns could pop up in the out-years, on the whole, the changes will likely allow companies—and shareholders—to prosper.

Major U.S. tax code overhauls are rare events, as they tend to occur only once every two or three decades. The recently enacted \$1.5 trillion bill, with its substantial business tax cuts and moderate reductions in individuals' tax burdens, is the most sweeping since the Reagan era. From our vantage point, the changes will be positive for the U.S. economy and equity market.

Key benefits for equity investors include:

- U.S. GDP should rise roughly half a percentage point more than it would have for at least the next two years, according to our economists. For example, instead of GDP growing by 2.5%, it could grow by 3.0% annually.
- The S&P 500 and other major indexes should see a meaningful boost in earnings growth.
- Industries with a large share of domestic revenues and high capital spending levels should capture the greatest incremental increases in free cash flow.
- Small-capitalization public companies and small private firms should see the biggest declines in tax rates as they previously paid the highest effective rates.
- The provision that allows companies to immediately deduct 100% of certain business expenses seems underappreciated. This can provide a big boost to cash flow.
- Momentum for business capital spending—a key component of GDP—should improve due to immediate deductibility.
- U.S.-based multinational firms that had high tax rates will be able to compete more effectively with low-taxed foreign rivals.
- Many companies will likely use the extra cash flow to initiate or increase stock buybacks, hike dividends, embark on acquisitions, and/or grow their businesses by other means—all of which can be positive for shareholders.

Market gets a head start

Some of this good news is likely priced into the stock market. It is well known for incorporating positive developments ahead of time, especially when they are well telegraphed, and this is no exception.

For example, as it became clearer the tax package could become a reality, the S&P 500 surged 5.0% from mid-November through the latter part of December just

before the bill passed both chambers of Congress. Additionally, the market's jump immediately following the 2016 presidential election was partly due to optimism about tax cuts and the Trump administration's other pro-growth initiatives.

Yearning for higher earnings

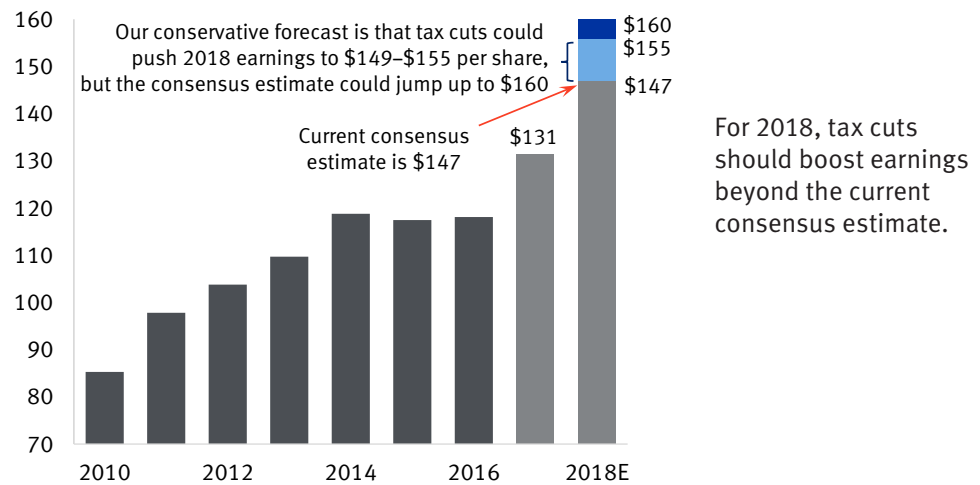
Even though the tax cut bill has already helped push the U.S. equity market higher, its full effect may not be completely factored in.

The positive corporate profits and cash flow impacts—the meat on the bones of the tax cut package—won't become fully visible until companies begin to incorporate the tax code changes into their 2018 earnings estimates. These upward earnings adjustments are not yet completely embedded into the consensus forecast, in our view, and therefore the positive impact on profits may not be totally discounted by the market.

Earnings growth could jump meaningfully in 2018 because the corporate tax rate has been slashed substantially.

Instead of the S&P 500 growing earnings at our 7.5% y/y estimated rate without tax cuts, we anticipate profits could expand 14%–18% or more with tax cuts in 2018. This higher growth range would represent \$149–\$155 per share in earnings, above the current \$147 consensus forecast compiled by Thomson Reuters I/B/E/S. But the consensus forecast could end up rising even higher—potentially up to \$160 per share, according to our national research correspondent.

S&P 500 annual earnings per share and estimates in USD



Source - Thomson Reuters I/B/E/S, RBC Wealth Management; 2017 and 2018 light gray data represent current consensus estimates

Earnings growth could jump meaningfully in 2018 because the corporate tax rate has been slashed substantially to 21% from 35%. This takes the U.S. from nearly the highest statutory rate in the world (only a handful of tiny economies have higher rates) to a rate well below the G7 and G20 averages, slightly below the European Union, and just a tad above the Asia average, according to the Tax Foundation.

If higher earnings growth pans out as we anticipate or is even stronger, it could push the market's valuation down to a more reasonable level (see [table on next page](#)). In any of these scenarios, the market's valuation would have room to expand in 2018 and potentially beyond, which is supportive of stock prices.

A less taxing situation

If higher earnings growth pans out as we anticipate or is even stronger, it could push the market's valuation down to a more reasonable level.

Forward price-to-earnings (P/E) scenarios based on full-year 2018 earnings estimates

Scenario	Earnings per share	P/E ratio
Our previous estimate without tax cuts	\$141	19.0x
Current consensus estimate	\$147	18.2x
Our new conservative estimate range with tax cuts	\$149– \$155	17.9x 17.2x
Where the consensus could possibly jump up to	\$160	16.7x

Any way we slice it, tax cuts should lower the U.S. market's valuation.

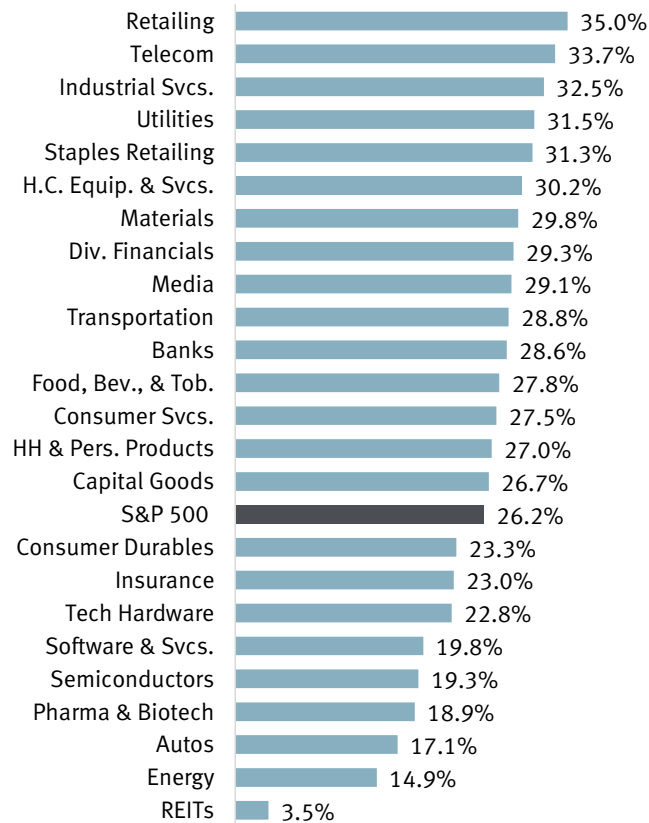
Source - RBC Wealth Management, Thomson Reuters I/B/E/S; data based on S&P 500 closing price of 2,673.61 on 12/29/17.

Domestically speaking

Domestically-focused industries, small-cap firms, and companies with high capital spending could see their tax rates drop and cash flows increase by the greatest magnitudes.

Among large-cap companies, many are in the retailing, telecommunications, industrials, utilities, and financials industries, and the list goes on (see chart).

Effective tax rates of select industry groups (before tax cuts)



Industries with the highest tax rates should benefit from tax cuts.

Source - National research correspondent, Thomson Financial, FactSet, Standard & Poor's; data based on 3-year trailing dollar weighted effective tax rate; data through 12/29/17

Companies will have additional flexibility to grow their businesses, compete globally, and prosper—to the benefit of employees and shareholders.

For example, without tax cuts, bank industry earnings seemed set to rise roughly 9% y/y in 2018. But with tax cuts, RBC Capital Markets believes the average growth rate could jump to 15%–19%.

As companies adjust their 2018 forecasts for tax cut benefits in coming months, investors will have a better picture of the biggest potential winners.

Concerns in the out-years

Even with all of the benefits for companies and equity investors, we would be remiss not to acknowledge the tax cut package is no panacea.

It could end up adding a trillion or so dollars to the national debt over time—a manageable, but still unwelcome amount given the federal debt-to-GDP ratio already ranges from 77% to 104%, depending on how it's calculated.

The tax cut package probably won't solve the country's wage growth or income disparity challenges in one fell swoop. Wages have been drifting moderately higher recently, but our U.S. economist doesn't expect the corporate tax cuts to drastically change the trajectory.

The tax reforms include some provisions that create uncertainties, or could turn out to be negative, for high-income taxpayers in high-tax states. While the legislation minimized the pain of the alternative minimum tax, at this stage it's unclear if that will fully or only partially offset the loss of a portion of state, local, and property tax deductions for these taxpayers, or if states can develop “workarounds.”

Some economists are questioning or criticizing the timing of the tax cuts. They argue that fiscal stimulus of this magnitude should come when the economy is struggling or attempting to gain its footing, not when it is at the strongest of the recovery cycle like now. While we are sympathetic of this theoretical argument, we are less bothered by the timing because the GDP growth trajectory of this recovery cycle is much lower than normal and the tax cut stimulus may not even push the economy back to the strong GDP growth rates reached in previous recoveries.

More troubling to us, the benefits of this tax bill could unwind in the out-years. A number of the provisions are temporary so they would need to be reauthorized by a future Congress and president or they will expire. If lawmakers are unwilling, tax cut tailwinds could become tax hike headwinds over time.

Lower taxes, higher expectations

Even with the bill's shortcomings, we cannot ignore the fact that the most significant tax cut package in 31 years has been enacted into law, a meaningful portion of which should benefit publicly traded companies. The earnings and dividend streams of U.S. companies seem set to rise due to tax cuts and the economy's underlying strength. The legislation should add to an already improving economic foundation and provide U.S.-based companies with additional flexibility to grow their businesses, compete globally, and prosper—to the benefit of employees and shareholders.

The material contained herein is for informational purposes only and does not constitute tax advice. Given that RBC Wealth Management does not provide tax or legal advice, clients should consult with a qualified tax advisor or attorney with regard to their personal tax situation.

Brexit U.K.: Put to the test



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The U.K.'s economic and political landscapes remain enveloped in a fog that shrouds the outlook for U.K. financial markets. Economic prospects are underwhelming due to Brexit uncertainty, while a weak and vulnerable government could face the challenge of early elections, throwing another spanner in the works. We advise prudence and reiterate our Underweight stance for U.K. equities.

The stress of divorce

For an open economy, where exports represent a hefty 31% of GDP and which enjoys full employment, the U.K. underwhelmed in 2017, particularly given the synchronised global recovery backdrop. This is likely to continue as the uncertainty related to Brexit seeps in.

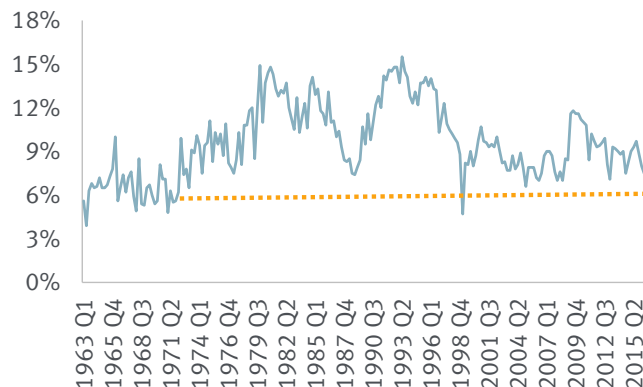
After expanding by just 1.5% (RBC Capital Markets estimate) in 2017, RBC Capital Markets forecasts the U.K. economy to grow a meagre 1.4% for 2018, among the weakest growth rates in the G7. Despite disappointing growth, the Bank of England (BoE) has begun tightening monetary policy so as to tame the now 3%+ inflation induced by the post-referendum slide in the pound. Its first hike in a decade boosted the bank rate to 0.5%.

Inflation should subside from now on thanks to base effects, but the BoE's recent messaging suggests it will increase rates by another 0.5% over the next three years. RBC Capital Markets believes this will largely be back-ended and looks for no increase in 2018 as Brexit uncertainty weighs on economic activity.

High inflation and subdued wage growth have eroded household disposable income. Consumers have stepped back somewhat. The household savings ratio, recently at an 18-year low, is likely to move higher with house price inflation now deteriorating, providing little reason to be optimistic about consumer outlays ahead.

U.K. household savings ratio is very low

Household savings as a % of disposable income



The low household savings ratio leaves the economy vulnerable to a further decrease in consumption.

Source - RBC Wealth Management, RBC Capital Markets, Haver Analytics; data through Q2 2017

Brexit U.K.: Put to the test

The risk of early elections and of a Labour government that would likely focus on an aggressive public spending agenda is underestimated, in our view.

Investment is not offsetting weak consumption. Business spending has suffered over the past 18 months, and whether it picks up will depend on how Brexit negotiations proceed. It is generally believed that unless there is more clarity by the end of Q1 2018 around the future trade relationship between the U.K. and the EU, businesses will restrict domestic investment projects.

Meanwhile, the government has scaled back austerity plans, postponing its deficit targets, though RBC Capital Markets does not expect government spending to add much to economic growth in 2018.

The pound gained 10% against the USD in 2017, propped up by monetary tightening expectations and the possibility Brexit negotiations would move on from settling “divorce issues” to discussing the future trade relationship.

Views are polarised about sterling’s prospects for 2018—the currency has the widest range of forecasts of any G7 country. On the one hand, a tighter monetary policy to control inflation might prop up the currency. On the other, the pound could be pressured by a weaker economy, or by inflation subsiding and removing the need for monetary tightening, or by challenging Brexit negotiations. RBC Capital Markets is in the latter camp, expecting renewed currency weakness in 2018.

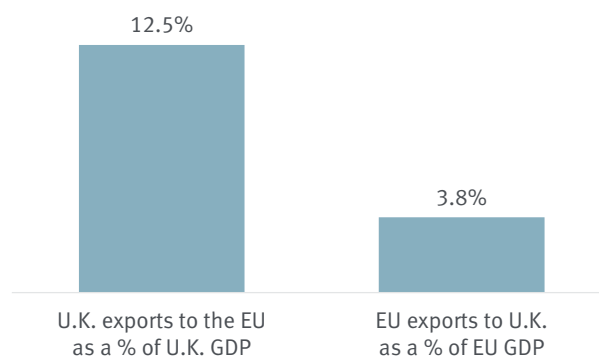
Between a rock and a hard place?

Brexit-related risks are well flagged, though the risk of early elections is underestimated, in our view. A Labour government that would likely focus on an aggressive public spending agenda, including nationalising certain industries, could be voted in.

Brexit is going ahead despite apparent economic costs in the short term. Polls suggest little regret concerning the referendum result. Having spent nine months settling the issues related to the separation of the U.K. from the EU, the U.K. has been given the go-ahead to start negotiations regarding a transition agreement and the terms of the new relationship.

This upcoming phase will likely prove even more challenging. The stakes are very high for the U.K. for whom the EU is a much more important trade partner than the U.K. is to the EU.

Exports as a percentage of GDP greatly differ



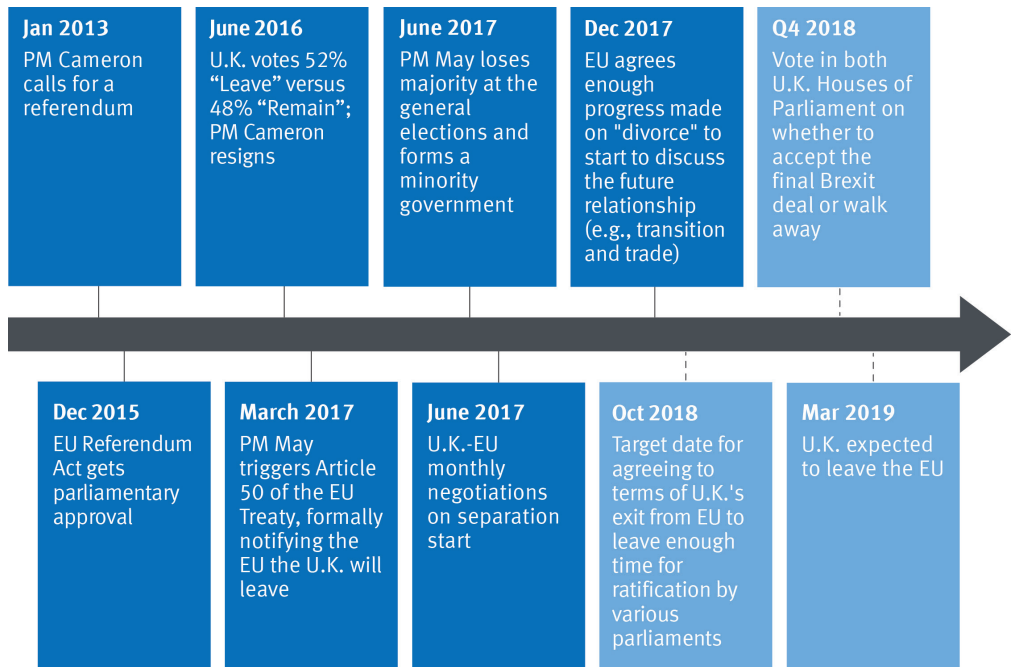
U.K. exports to the EU are much more significant to the U.K. economy than the other way around.

Source - RBC Wealth Management

Brexit U.K.: Put to the test

Complicating matters further, U.K. politicians are not in agreement as to what they are trying to negotiate and what, if anything, would replace the EU single market and customs union memberships. The clock is ticking. Negotiations need to be completed within nine months to leave enough time for any new agreement to be ratified by parliaments in the U.K. and EU before the U.K. leaves the EU on March 29, 2019.

Brexit timeline



Source - RBC Wealth Management, RBC Capital Markets

Our base case is that the U.K. will aim for a two-year transition period after the set March 2019 exit date to extend the status quo.

Given the stakes, there is a non-negligible probability of a breakdown in talks and of the economically damaging "hard Brexit" scenario materialising. Under such an outcome, the U.K. would lose tariff-free access to its largest export market and have to fall back on WTO rules. This would entail not only tariffs, but also having to meet the burdensome cost of abiding by complex "rules of origin" regulation. A hard Brexit scenario would be negative for the pound and would probably result in higher Gilt yields.

Our base case is that the U.K. will aim for a two-year transition period after the set March 2019 exit date to extend the status quo, and defer the settling of the details of the future relationship to a later date.

The second risk, with arguably a wider range of consequences, is the spectre of early elections. Prime Minister Theresa May's government is weak with a razor-thin working majority of only 13. With Brexit negotiations dividing the government, there is a material probability of a general election before the end of 2019, or some two years before elections are due. A Labour Party win is a real possibility, in our view, given Labour's surge in the polls since mid-2017.

The Labour Party has shed its centre-left stance and now backs a programme of nationalisations and has suggested an additional £500B in spending to be financed by higher Gilt issuance, which is likely to increase both inflation and Gilt yields.

The party is deeply divided on Brexit, and so far has had an ambiguous stance on the matter, though it has not opposed the government's position.

A wide array of outcomes is possible for financial markets. On the one hand, should Labour win a sweeping majority and push for a hard Brexit, U.K. financial markets would almost certainly come under pressure. This scenario is not very likely, but U.K. politics have proven to be unpredictable of late.

In a more benign scenario, Labour would emerge victorious but without a majority of seats, making it more difficult to pass extreme measures. Should it also shift its stance on Brexit and opt for a Norway-style agreement where access to the single market is retained, it is conceivable the pound and economy could both strengthen. There are many other potential permutations to be considered.

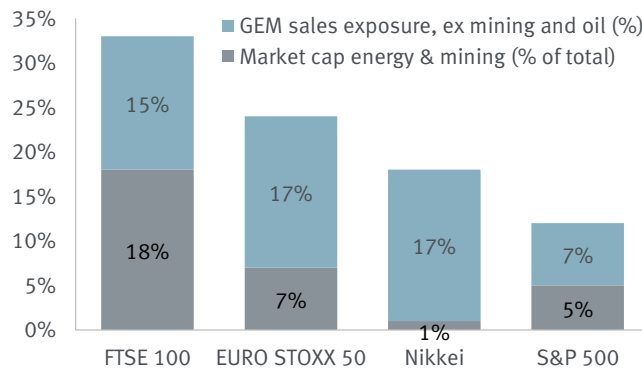
U.K. equities: Fog of uncertainty

In our view, U.K. equities present a less attractive proposition than those of other regions despite more appealing valuations. U.K. equities have lagged in 2017 and we think this is set to continue in 2018 given the unappetising stew of severe political risk and a comparatively weak economy.

U.K. equities look especially cheap compared to other markets, particularly on a price-to-book value basis, partly due to the structural derating of banks and commodities. On a forward price-to-earnings basis, excluding commodities, the U.K. trades at a 10% discount to global markets, a level it hasn't seen in nearly 10 years.

In our view, U.K. equities present a less attractive proposition than those of other regions despite more appealing valuations.

Emerging markets and commodities exposure is high



The fate of U.K. equities is also linked to emerging markets and commodities.

Source - RBC Wealth Management, National research correspondent

Such cheapness is warranted, in our view, given the risks enumerated above. The consensus earnings growth expectation of less than 6% for 2018 is comparatively unconvincing. With the number of profit warnings at a six-year high in Q3 2017, earnings expectations may well be reined in further.

Moreover, as a high dividend-paying market, yielding 4% overall, the U.K. has tended to underperform when monetary policy is tightened. U.K. equities are also still largely exposed to commodities and emerging markets, which are both highly sensitive to the U.S. dollar. Should the dollar rally, as RBC Capital Markets expects, it could also contribute to restraining U.K. equity performance.

Brexit U.K.: Put to the test

We expect volatility to increase and for better entry points for equity, fixed income, and foreign exchange investors to materialise in the months ahead.

Some argue that, should the pound weaken markedly due to a breakdown in negotiations, U.K. equities could rally, much like they did after the referendum results. We concede that a cheap pound could eventually attract buyers, but worry a breakdown in talks could also be interpreted as the worst scenario materialising, in which case, the inverse relationship of the pound falling but equities gaining may well dissipate. The outlook is finely balanced.

We remain selective, preferring high-quality businesses with sound balance sheets, robust cash flow generation, and a track record of compounding returns to shareholders. We maintain our bias towards international exposure, focusing on companies exposed to either a strongly growing Europe or to U.S. tax reform, or both. We would steer clear of companies in the potential crosshairs of nationalisation (utilities, transport) and believe that despite their underperformance, it is still too early to step back into domestic stocks.

With the U.K. outlook mired in uncertainty, we expect volatility to increase and for better entry points for equity, fixed income, and foreign exchange investors to materialise in the months ahead.

Synchronicity

2018 looks to be a year of sustained expansion in every major economy. Synchronised global growth, largely absent over the past seven years, emerged last year. Canada had back-to-back quarters of 3%–4% GDP growth mid-year. U.S. growth topped the elusive 3% mark in Q2 and Q3, despite two mammoth hurricanes. The fourth quarter looks to have been as strong.

Europe has also picked up the pace. After flirting with yet another recession two-and-a-half years ago, the eurozone economy managed to develop some upward momentum, finishing 2016 up by a much better than expected 1.7%, improving further to 2.3% (est.) in the year just ended. It should do as well in 2018, as economic activity indexes point to a strong start. The improvement has been broad-based: most economies are participating. Germany is no longer carrying the load alone.

Meanwhile, Japan, the world's third-largest economy, has completed seven consecutive quarters of positive GDP

Equity views

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

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

growth—the first such streak in almost 17 years.

China's growth has become more balanced—debt is at last growing no faster than the economy. And important emerging economies like Brazil's and Russia's are rebounding out of deep downturns while India's growth has reaccelerated back above the 6% mark.

For most economies, today's improved GDP growth rates are still below those posted in the heady years leading up to the financial crisis, helping to keep inflation at bay. Central banks in North

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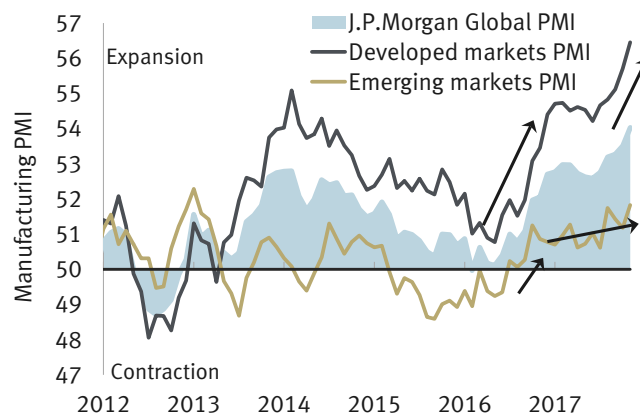
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Global manufacturing expansion continues



Manufacturing is on a roll ...

Note: PMI refers to Purchasing Managers' Index for manufacturing sector, a measure for economic activity
Source - Haver Analytics, RBC Global Asset Management

America and Europe are very gradually moving away from the extraordinarily accommodative policies of the past eight years.

From the global equity investors' perspective, here's how the table is set:

- Global economies are expanding in a synchronised fashion for the first time in seven years. The pace of that expansion has recently picked up.
- Most central banks remain extremely accommodative even as they move toward very gradually “normalising” policy. Credit conditions restrictive enough to produce a global downturn or, in particular, a U.S. recession, are nowhere in sight.
- Earnings, after several years of decline/stagnation, turned higher a year-and-a-half ago and are now near or above all-time highs. Managements' guidance, even those made long before U.S. tax cuts looked plausible, have been very upbeat, correctly signaling the strong growth delivered in 2017 with another good gain expected this year.

Looking at the U.S. equity market, the S&P 500 began 2017 at 19.1x trailing

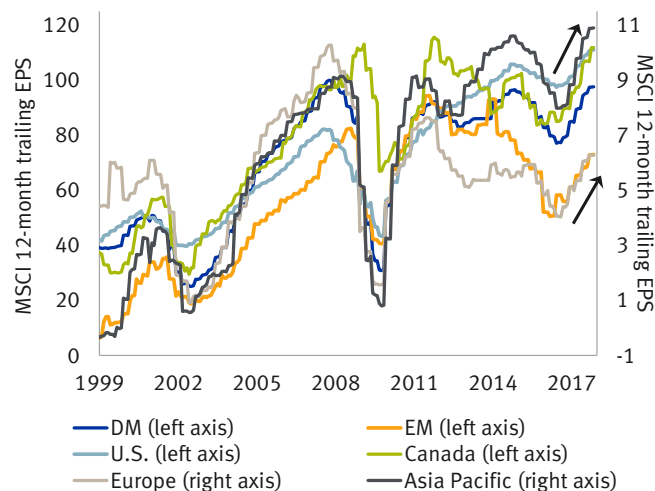
12-month earnings and finished the year at **20.4x**. As 2018 got underway, earnings were forecast to grow by 7% before tax cuts and by at least 12% when those cuts are factored in. That puts the index somewhere between 18x and 19x those forecasts.

By comparison, Canada's TSX is trading at 16.6x 2018's expected earnings while European stocks are at 15.0x. We don't find today's P/Es an impediment to equity markets delivering worthwhile gains this year, particularly if earnings grow as forecast.

The path to those gains is unlikely to be smooth. It's not difficult to imagine developments that could produce bouts of volatility. NAFTA is front of mind in Canada. Politics and Brexit preoccupy Europeans. Mid-term elections are on the way in the U.S. along with a clearer elaboration of the administration's trade policy imperatives—likely to be worrying to many outside the U.S.

Our indicators suggest no recession is in sight. We are inclined to go on giving equities the benefit of the doubt through 2018 and probably beyond.

Global corporate profits rising



... as are earnings.

Note: Earnings per share (EPS) in U.S. dollars for developed markets (DM), emerging markets (EM), U.S., and Asia Pacific; euros for Europe; Canadian dollars for Canada

Source: MSCI, Bloomberg, RBC Global Asset Management

Regional highlights

United States

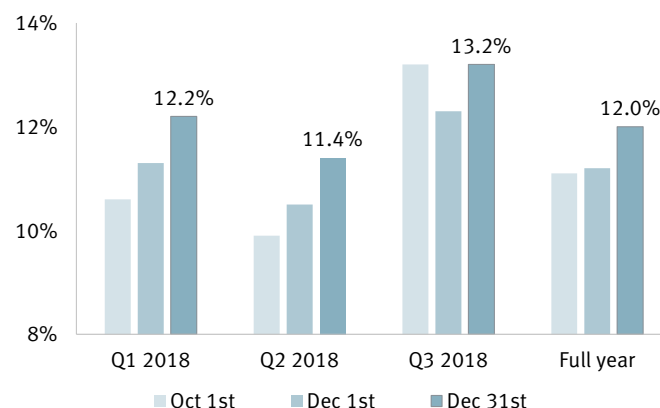
- We remain constructive on the U.S. equity market for 2018 given our positive outlook for the domestic and global economies, and benefits from the tax cut package, combined with low recession risks.
- The U.S. is in the midst of its third-longest economic expansion since WWII, a cycle which is within reach of becoming the longest on record. While cumulative GDP growth has significantly lagged other periods, its trajectory seems to be picking up as the economy builds on recent momentum and is boosted by tax cuts and ongoing deregulatory efforts.
- U.S. equity returns should be driven by rising profitability and some modest multiple expansion. This year, underlying economic strength and tax cuts should push the earnings growth rate above the 12% level achieved in 2017. We anticipate increased stock buybacks and dividend hikes, along with stronger merger and acquisition activity—all of which can benefit shareholders.
- We'd be surprised, however, if there weren't at least a pullback in 2018, if

not a 10% or more correction. The market has traveled a long way for a long time without one. So while we believe U.S. stocks are well positioned to deliver attractive gains over the course of the year, investors should expect some bumps along the way.

Canada

- We are Market Weight Canadian equities, reflecting our outlook for key market segments. Banks are fairly valued given expectations for slowing mortgage originations, supportive credit trends, and modest earnings growth. Our outlook for the energy complex is muted in light of expectations for robust U.S. supply growth.
- RBC Capital Markets revised its forecast for North American benchmark crude oil prices to US\$54 per barrel in 2018 (from US\$51) and US\$56 in 2019 (from US\$54) though it expects crude oil prices to remain range-bound as U.S. output growth swells in 2018.
- The S&P/TSX significantly underperformed global equity benchmarks in 2017 including the S&P 500. As a result, the valuation discount of the S&P/TSX relative to

2018 earnings growth estimates over time



The synchronized global expansion and low recessionary risks, U.S. tax reform, and consumer activity contributed to double-digit and rising earnings expectations heading into 2018.

Source - RBC Wealth Management, Thomson Reuters I/B/E/S; data through 12/31/17

the S&P 500 has widened further. This valuation discount reflects a number of uncertainties and potential risks that we continue to monitor: any adverse change to NAFTA, the impact of higher borrowing costs on domestic consumers, and the uncertain trajectory of energy prices.

- Factors that could prompt a more positive stance on Canadian equities are greater comfort around the medium-term outlook for crude oil and greater visibility on a satisfactory resolution to NAFTA renegotiations.

Continental Europe & U.K.

- European equities markets were up 9% in 2017 in local currency terms, though USD investors would have enjoyed much larger gains (+24%) enhanced by the strength of the currency. We expect 2018 will be another constructive year and continue to recommend an Overweight stance in the region.
- The recent recovery is pleasingly broad-based, with all countries now enjoying growth. It is being led by stronger domestic demand, and with economic and political uncertainty waning, there are now signs business investment, up until now elusive, is also making a comeback. This bodes well for the sustainability of the recovery.
- Valuations are not much above their long-term average, on 15x forward P/E multiples and thus still leave room for upside, in our view. Moreover, compared to the U.S., the region remains very attractively priced. With RBC Capital Markets expecting the currency to go mostly sideways in 2018, we would recommend any European equity exposure to be unhedged.

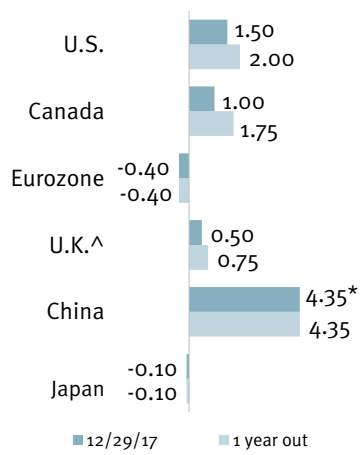
- Given the cyclical recovery, we like companies exposed to the domestic economy, including well-capitalised banks. With long yields poised to move gradually higher, banks should be well-supported. Moreover, the region has tended to do well when long yields rise. Small caps also offer opportunities on a selective basis.

Asia

- After an outsized performance in many Asian equity markets in 2017, we expect more modest returns in 2018. The MSCI AC Asia Pacific Index rose by 26.7% (January 1 through December 20), with particular strength in the Hang Seng Index, up 32%.
- We believe the probability of a pullback or correction is elevated, and the key risk factor is an end to the steady Chinese economic data. We expect the Chinese property market to soften moderately in 2018 and believe that financial deleveraging will form a headwind, although to what extent is difficult to judge. 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.
- The Japanese equity market has reached levels not seen in over 25 years. The earnings outlook and valuations are still somewhat supportive of equities. But, the chance of consolidation or a pullback in equities is moving higher after a very impressive performance over the past 18 months. All else equal, a pullback would be a buying opportunity. Inflation is modestly positive—arguably the key achievement of Abenomics. Key risks include currency appreciation and weakening global economic indicators.

A few of our favorite things

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

“Green shoots” became a popular phrase in the wake of the Great Recession, denoting cautious optimism about the outlook for an economy. So often, however, the green shoots went dormant and the predicted growth failed to materialize, keeping interest rates unusually low. But as we enter 2018, major global economies appear to finally be in sync and for next year a few of our favorite things investors should pay attention to include growth (GDP), inflation, and yield curves.

Across most major geographies, moderate growth and tame inflation is a developing theme although each economy is at a different stage in the cycle. In its ninth year, the U.S. economic expansion is clearly more mature and should benefit in the short-run from tax reform. As the chart on the next page indicates, economic expansions in Canada and Europe can't yet boast of a comparable growth trend and the U.K. will remain weighed down by Brexit, but the signs overall point to continued growth through 2018 and perhaps beyond.

Central bank policy has and will continue to be essential to continued expansion. Even though the Fed is leading others toward reduced accommodation and policy normalization, the process will be very gradual, especially as inflation in most instances (except the U.K.) remains below the common 2% target.

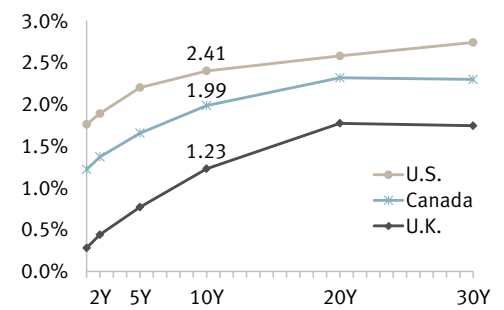
The bane for central banks could very well be further yield curve flattening. With many sovereign curves at their flattest levels in years (and likely to remain so), our view is central bankers will not willingly invert their

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

respective yield curves via reduced accommodation. For the Fed, to us, this could mean just two rate hikes in 2018 versus the three penciled in at the Federal Open Market Committee and currently expected by the market.

Regional highlights

United States

- Tax reform provided a year-end boost to 10Y U.S. Treasury yields, which closed out 2017 at 2.41%, up just 4 basis points for the year. But expectations the Fed could be quick to follow with further rate hikes kept pressure on short-term rates, further flattening the yield curve. We expect the shape of the curve to continue

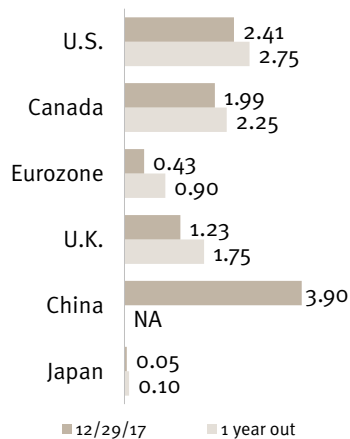
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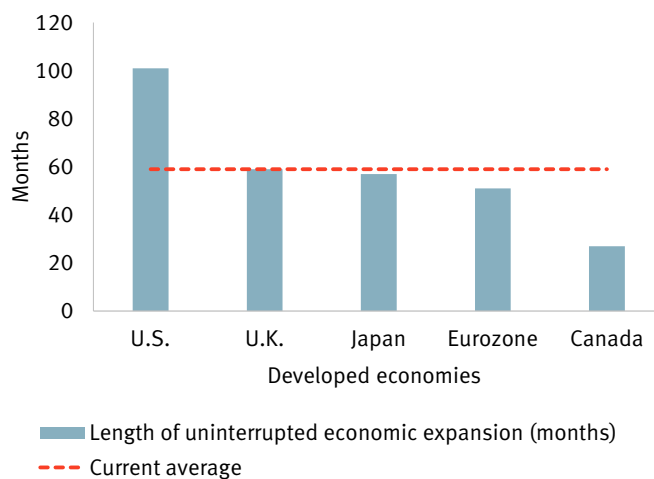
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10-year rate (%)



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

Not all expansions are created equal



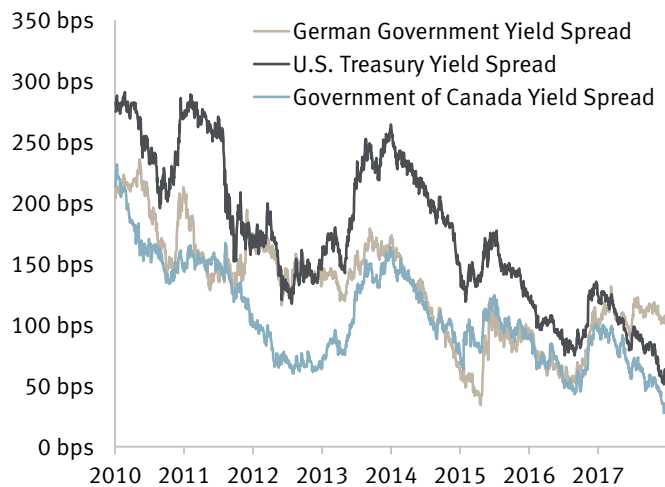
The U.S. expansion is in its ninth year, while others have more room to run.

Source - RBC Wealth Management, Bloomberg, data through 9/30/17

to be a major market theme in 2018, and see a flat yield curve increasingly challenging the Fed's plans for three rate hikes this year.

- We still see the 10Y holding below 2.75% in 2018 as that is the Fed's December 2017 estimate for the terminal Fed Funds rate. Our research indicates that during the past two tightening cycles, the 10Y has peaked in line with the terminal rate.
 - Tax reform may be a mixed bag for speculative grade credit markets, as the package includes a provision that limits the amount of interest payments firms can deduct, which could stress highly-indebted companies. Ultimately, firms may be reluctant to increase debt loads, which may be a credit positive for investors.
 - We expect municipal bond issuance to decline in Q1 2018 as tax reform eliminated one muni structure—Advanced Refundings. Individual tax rates were lowered only modestly and with competitive yields and high quality, we see continued strong demand and reduced issuance as supportive factors for muni prices.
- ### Canada
- The Government of Canada yield curve has reached its flattest level since 2008. A move lower in longer-dated yields, now below their six-month averages, is the reason for the current shape and reflects both a more modest growth outlook and a lack of inflationary pressure. The shape of the curve, combined with the lower absolute level of longer-dated yields, reduces the appeal of extension trades and keeps our attention on short-to-intermediate maturity bonds.
 - Credit spreads in Canada are at three-year lows despite record high levels of supply. Investor demand remains robust for corporate bonds thanks to the low yields on alternative assets as well as the healthy economic backdrop. We continue to recommend a selective approach when moving down the capital structure as well as diversification by geographic exposure.
 - Preferred shares have underperformed into year end as the market is digesting a recent pick-up of issuance. We remain constructive on the prospects for preferred

North American yield curves at flattest levels of the current recovery



A lack of inflationary pressures continues to keep longer term yields low, flattening global yield curves.

Source - RBC Wealth Management, Bloomberg; data through 12/29/17

shares due to interest rate forecasts, demand and supply imbalances, and attractive valuations. Our strategy remains diversified across share structure and issuers.

Continental Europe & U.K.

- The eurozone growth backdrop continues to improve. Nevertheless, inflation should remain stubbornly low, given the region is behind the U.S. in its credit cycle and excess capacity is relatively high. This, and a central bank that does not plan to increase rates whilst it continues to buy bonds, means we don't expect rate hikes in 2018.
- These low rates will anchor bond yields and although potential volatility in U.S. bond markets could impact German Bunds, we believe weakness should be transitory given the ECB's dovish stance.
- The strength of the eurozone economy will also be supportive for corporate bonds, and we expect cyclical industries to be a chief beneficiary.
- In November, the BoE hiked the Bank Rate for the first time since 2007, and although this was enacted in response to high inflation, we don't expect further increases given Brexit-related headwinds to the economy. The volatility of the Gilt market in the first weeks of December has served to highlight how vulnerable Gilts are to headline risks that emanate as Brexit negotiations proceed. Despite a recent breakthrough in talks, we expect this volatility to continue as the EU is taking a tough opening position on transition and the future economic relationship with the U.K.
- The prospect for a Labour party-led government preoccupies us as we consider risks to U.K. assets are underpriced given the potential for looser fiscal policy and a more hawkish monetary policy. This combination would drive Gilt yields higher.
- We prefer credit over Gilts, and are relatively comfortable with interest rate risk.

All that glitters in 2018 ... is not gold

Commodity forecasts

	2018E	2019E
Oil (WTI \$/bbl)	54.00	56.00
Natural Gas (\$/mmBtu)	3.00	3.00
Gold (\$/oz)	1,303	NA
Copper (\$/lb)	3.00	3.25
Corn (\$/bu)	3.78	3.90
Wheat (\$/bu)	4.54	4.70

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

Gold prices had a strong 2017, despite some brief periods of weakness. Even with the recent Fed rate hike, weaker-than-normal physical demand in India, and a continued rally in equities, gold ended the year up roughly 13%. Most of the strength can be attributed to weakness in the USD and sporadic geopolitical headlines. However, looking at 2018, we expect a number of headwinds to weigh on gold prices for the year to come.

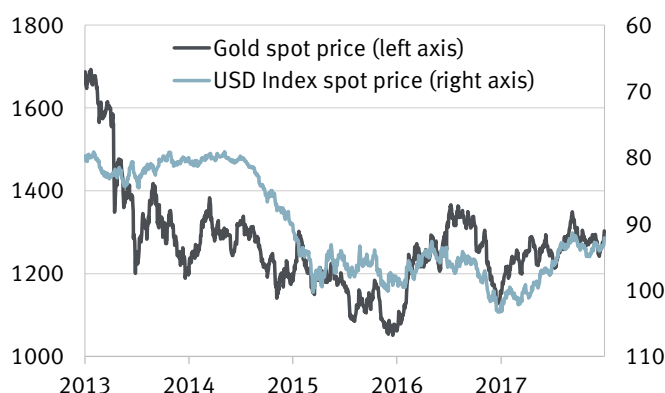
Most importantly is the macroeconomic environment. The International Monetary Fund forecasts moderate, sustained economic growth across most regions of the globe, but still expects inflation to be weak, indicating slack in many economies has yet to be eliminated. In this type of environment, equities tend to rally, and the need to hold gold as a store of value decreases. And with a few rate hikes expected in 2018, the USD may be set to strengthen. Since gold is denominated in U.S. dollars, it tends to move inversely to the greenback.

The supply profile of gold looks stable, and RBC Capital Markets forecasts slightly lower mine supply, but higher scrap supply and little change in net producer hedging. However, demand could strengthen, with RBC Capital Markets predicting higher volumes from both jewelry and bar and coin demand, suggesting there could be modest upside to bullion prices.

The sudden rise of Bitcoin this year has led some to question whether digital currencies are attracting investors away from gold. While some commodity experts believe there may be some merit to that idea, it is unlikely bitcoin or any digital currency could replace gold in the foreseeable future given the latter's unrivaled reputation as a store of value for traditional long-term investors.

RBC Capital Markets forecasts the 2018 average gold price at \$1,303/oz, the exact price at the end of 2017. But while returns are expected to be flat, RBC Capital Markets believes the risks are skewed to the upside given the always-present potential for renewed geopolitical upheaval.

Gold spot price vs. USD Index spot price



Strength in the USD could put pressure on bullion prices.

Source - RBC Wealth Management, Bloomberg; data through 12/29/17

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Currencies

Currency forecasts

Currency pair	Current rate	Forecast Dec 2018	Change*
Major currencies			
USD Index	92.12	97.22	6%
CAD/USD	0.79	0.79	0%
USD/CAD	1.25	1.27	2%
EUR/USD	1.20	1.14	-5%
GBP/USD	1.35	1.23	-9%
USD/CHF	0.97	1.11	14%
USD/JPY	112.69	120.00	6%
AUD/USD	0.78	0.73	-6%
NZD/USD	0.70	0.69	-1%
EUR/JPY	135.28	137.00	1%
EUR/GBP	0.88	0.93	6%
EUR/CHF	1.17	1.26	8%
Emerging currencies			
USD/CNY	6.50	7.30	12%
USD/INR	63.87	65.20	2%
USD/SGD	1.33	1.47	11%

* 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: Ready for a comeback?

The dollar appears poised to recover after broadly underperforming throughout 2017. Firm economic growth and a tight labour market argue for further normalizing/tightening of monetary policy, something the market continues to be cautious about. While a possible flare-up of political uncertainty and lack of inflationary pressures could derail the Fed from its projected path of rate hikes and knock the dollar off course, we expect these risks to be contained, leaving room for dollar strength.

Euro: Robust growth, but rates steady

The European Central Bank will likely remain very cautious regarding rate hikes for at least the next 18 months as slack in the labour market is expected to keep inflationary pressures subdued. We expect interest rate rises will only emerge well past the end of the quantitative easing programme, currently scheduled for September. The market is more aggressive, factoring in earlier rate increases, than we foresee. The likely readjustment of these expectations underpins our neutral outlook for the currency.

British pound: Resiliency at risk

Recent progress on Brexit negotiations only clears the first hurdle in what is

expected to be a challenging and lengthy process. The EU and U.K. have agreed to move to the next phase of talks—discussion of transition and the future trading relationship. We still believe the pound will head lower over time against a confluence of inflation dynamics, an attendant pause in rate hikes by the Bank of England, and domestic economic and political challenges.

Canadian dollar: On pause, for now

A dovish tone continues to emanate from the Bank of Canada as a wait-and-see approach to how the economy adjusts to earlier rate hikes prevails. Elevated household debt, subdued inflation, and uncertainty surrounding NAFTA renegotiations should keep the current policy stimulus in place until mid-2018. But, we think the need for additional rate hikes will become more evident through 2018. Any convergence with U.S. monetary policy will provide scope for renewed CAD strength.

Japanese yen: Standing still

Expansionary policies of the government and, implicitly, the Bank of Japan should remain in place through 2018 against a subdued inflationary backdrop. In a world gradually moving towards normalising monetary policy, the yen runs the risk of standing still as other central banks start to tighten.

Dollar appears poised to recover in 2018



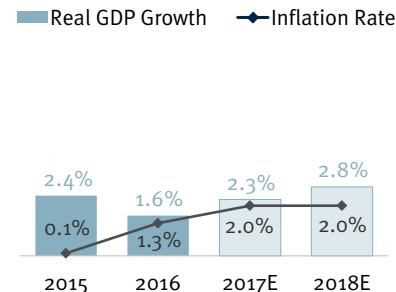
Dollar could shift into higher gear after underperforming in 2017.

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Source - RBC Wealth Management, Bloomberg; data through 1/3/18

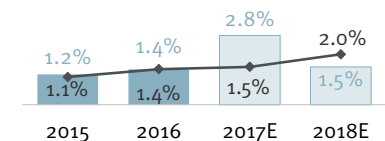
United States — All systems go

- Data returned to normal following two hurricane-skewed months. Small business optimism highest in 38 years on tax cuts. Consumer confidence mixed. Fed hiked rates in December for 3rd time in 2017. Balance sheet unwinding set to increase this month. Q3 GDP revised to 3.2%, 2nd consecutive quarter at +3% growth. Home sales strengthened despite low supply.



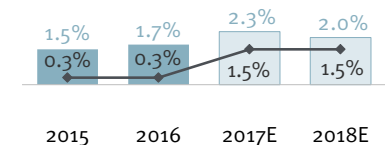
Canada — Energy led inflation

- Bank of Canada remains data-dependent. Headline inflation accelerated to 2.1% y/y, from 1.4% one month prior; however, the increase is due to energy price rises. Retail sales rebounded 1.5% over the month after three consecutive weak months. Housing data remains mixed. GDP growth stalled to flat m/m. Pace of hiring impressive, unemployment rate fell below 6% for first time since '08.



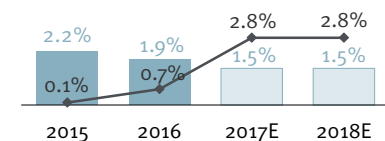
Eurozone — A hawkish ECB?

- European Central Bank spurred a global bond selloff with hawkish comments. Bank now looking to use interest rates to adjust monetary policy, not the current asset purchase program. Eurozone Q3 GDP firmed to 2.6% y/y. Retail sales stumbled to 0.4% y/y, from 1.6% y/y prior. PMIs continue to point to continued economic expansion ahead.



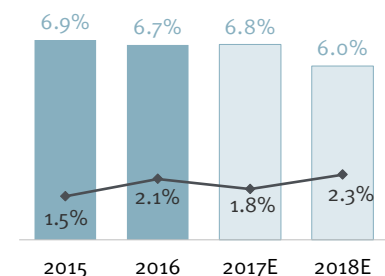
United Kingdom — BoE to remain patient

- Core inflation paused at 2.7% y/y, after post-Brexit acceleration, but remains well above target. Q3 GDP accelerated to 1.7% y/y on unexpected strength in business investment. Bank of England holds policy rate and asset purchase target. Economist expectations are for next rate hike a 2019 event.



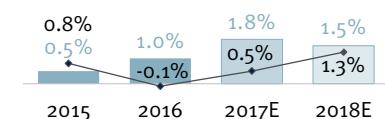
China — Slow and steady

- Retail sales remain robust at 10.2% y/y. Import growth outpaced export growth; however, the trade balance stands at \$40B in net exports that are expected to increase as major trading partners' PMIs at highest levels since 2010. Inflation remains controlled at 1.7% y/y and manufacturing activity robust at 6.6% y/y growth in industrial production.



Japan — Picking up

- Q3 GDP slowed to 0.6% q/q from 0.7% q/q in Q2. Jobless rate fell to lowest level since 1993 as demand for full-time labor outpaced supply. Household spending rose more than expected, while inflation sits at 1.0%. Bond market participants will place more attention on inflation next year given rising oil prices. Perhaps the biggest event will be the Bank of Japan discussions on when to exit monetary stimulus.



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	2,673.61	1.0%	19.4%	19.4%
Dow Industrials (DJIA)	24,719.22	1.8%	25.1%	25.1%
NASDAQ	6,903.39	0.4%	28.2%	28.2%
Russell 2000	1,535.51	-0.6%	13.1%	13.1%
S&P/TSX Comp	16,209.13	0.9%	6.0%	6.0%
FTSE All-Share	4,221.82	4.7%	9.0%	9.0%
STOXX Europe 600	389.18	0.6%	7.7%	7.7%
EURO STOXX 50	3,503.96	-1.8%	6.5%	6.5%
Hang Seng	29,919.15	2.5%	36.0%	36.0%
Shanghai Comp	3,307.17	-0.3%	6.6%	6.6%
Nikkei 225	22,764.94	0.2%	19.1%	19.1%
India Sensex	34,056.83	2.7%	27.9%	27.9%
Singapore Straits Times	3,402.92	-0.9%	18.1%	18.1%
Brazil Ibovespa	76,402.08	6.2%	26.9%	26.9%
Mexican Bolsa IPC	49,354.42	4.8%	8.1%	8.1%
Bond yields	12/29/17	11/30/17	12/30/16	12 mo. chg
US 2-Yr Tsy	1.883%	1.782%	1.188%	0.69%
US 10-Yr Tsy	2.405%	2.410%	2.444%	-0.04%
Canada 2-Yr	1.689%	1.432%	0.747%	0.94%
Canada 10-Yr	2.045%	1.889%	1.721%	0.32%
UK 2-Yr	0.438%	0.521%	0.084%	0.35%
UK 10-Yr	1.190%	1.330%	1.239%	-0.05%
Germany 2-Yr	-0.627%	-0.684%	-0.766%	0.14%
Germany 10-Yr	0.427%	0.367%	0.208%	0.22%
Commodities (USD)	Price	1 month	YTD	12 month
Gold (spot \$/oz)	1,303.05	2.2%	13.1%	13.1%
Silver (spot \$/oz)	16.94	3.1%	6.4%	6.4%
Copper (\$/metric ton)	7,207.00	7.0%	30.5%	30.5%
Uranium (\$/lb)	23.88	18.2%	17.2%	17.2%
Oil (WTI spot/bbl)	60.42	5.3%	12.5%	12.5%
Oil (Brent spot/bbl)	66.87	5.2%	17.7%	17.7%
Natural Gas (\$/mmBtu)	2.95	-2.4%	-20.7%	-20.7%
Agriculture Index	282.14	-0.6%	-3.0%	-3.0%
Currencies	Rate	1 month	YTD	12 month
US Dollar Index	92.1240	-1.0%	-9.9%	-9.9%
CAD/USD	0.7955	2.6%	6.9%	6.9%
USD/CAD	1.2571	-2.5%	-6.5%	-6.5%
EUR/USD	1.2005	0.8%	14.1%	14.1%
GBP/USD	1.3513	-0.1%	9.5%	9.5%
AUD/USD	0.7809	3.2%	8.3%	8.3%
USD/JPY	112.6900	0.1%	-3.7%	-3.7%
EUR/JPY	135.2800	1.0%	10.0%	10.0%
EUR/GBP	0.8881	0.9%	4.1%	4.1%
EUR/CHF	1.1703	0.0%	9.2%	9.2%
USD/SGD	1.3360	-0.9%	-7.7%	-7.7%
USD/CNY	6.5067	-1.5%	-6.3%	-6.3%
USD/MXN	19.6590	5.5%	-5.2%	-5.2%
USD/BRL	3.3085	1.2%	1.8%	1.8%

The tech heavy NASDAQ was the best performing U.S. index led by strong gains in the FAANG stocks.

2-Year Treasury yields highest in almost a decade following three Fed rate hikes in 2017.

Copper was 2017's best performing commodity on expectations of accelerating global growth.

Euro rallies to levels not seen in three years, however, the 1.21 level can be viewed as technical resistance.

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 0.79 means 1 Canadian dollar will buy 0.79 U.S. dollar. CAD/USD 6.9% return means the Canadian dollar has risen 6.9% vs. the U.S. dollar during the past 12 months. USD/JPY 112.69 means 1 U.S. dollar will buy 112.69 yen. USD/JPY -3.7% return means the U.S. dollar has fallen 3.7% vs. the yen during the past 12 months.

Source - RBC Wealth Management, RBC Capital Markets, Bloomberg; data through 12/29/17.

Research resources

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			Count	Percent
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Hold [Sector Perform]	683	41.24	155	22.69
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