



Asset class commentary

Despite the advancing business cycle and less-compelling equity valuations, it's too early to call the end of the bull market. Equities are not as attractive as they were at previous points in the cycle, but there is still potential upside in corporate profits. The outlook for bonds remains unexciting, but the recent increase in yields has lowered valuation risk and bonds are critical in balancing against rising volatility and/or unexpected deterioration in corporate profits. We have held large underweights in fixed income for a long time, but have been narrowing that gap as the business cycle matures and yields rise. Nevertheless, we expect stocks to continue outperforming bonds and have maintained a mild overweight in equities.

Fixed income

Our models continue to suggest that the long-term direction for bond yields is higher, but the meaningful increase in yields over the past quarter has alleviated valuation risk in the near term. Bond yields are already reflecting expected inflation premiums so, barring an inflation shock, any meaningful increase in the U.S. 10-year bond yield over the coming years is likely to come from a rise in real (after-inflation) interest rates. In our view, real interest rates are unlikely to remain well below their long-term average now that the economy has regained its footing. The resulting upward pressure from rising real rates on nominal bond yields means that fixed income may act as a drag on investment returns for many years.

Regional outlook for equities

Canada

The S&P/TSX Composite Index closed 2017 as the worst-performing developed-world equity market and continued to underperform into 2018, falling 2.7% during the three-month period ended February 28, 2018, while the S&P 500 Index gained 3.0% and the MSCI World Index advanced 2.3% (in U.S.-dollar terms). Underperformance was likely due in part to concerns about the sustainability of domestic economic growth and competitiveness as well as uncertainty about the outcome of NAFTA negotiations.

NAFTA negotiations, the housing market and higher interest rates remain potential headwinds for the Canadian economy and equity markets, but the economy has exhibited some strength with impressive employment gains last year. We expect Canadian GDP growth to moderate in 2018 to 1.75% after last year's solid gain of 3.0%. In January, the Bank of Canada (BoC)

recently raised its policy rate by 25 basis points to 1.25% and slightly lifted its GDP growth forecasts, noting that business and infrastructure investment will supplant consumer spending and housing as the drivers of economic growth. We expect the BoC to hike its policy rate to 1.75% over the next 12 months. The U.S. Federal Reserve (Fed) raised its rate by 25 basis points on March 21, 2018, and we expect rates to rise another 75 basis points to 2.38% this year. Policy-rate and yield differences between Canada and the United States are likely to set the path for the Canadian dollar going forward.

Market expectations for S&P/TSX aggregate earnings are \$990 in 2018 and about \$1,100 in 2019, representing increases of 10% and 12%, respectively. The biggest contributions to earnings growth this year are expected to come from the Financials, Energy and Materials sectors. We believe the S&P/TSX Composite Index is fairly valued and carries slightly less market confidence than the S&P 500 Index, which seems justified given the concerns outlined above and the fact that the Financials and Energy sectors account for more than half of the Canadian market's earnings.

“NAFTA negotiations, the housing market and higher interest rates remain potential headwinds for the Canadian economy and equity markets, but the economy has exhibited some strength with impressive employment gains last year.”

United States

The U.S. stock market recorded average returns over the past three months ended February 28, 2018, rising 2.5%. Positive performance in economically sensitive sectors was driven by the continued synchronized global economic expansion, still-accommodative global central-bank policies and low market interest rates and inflation, which produced better-than-expected profits for many U.S. companies. Bond yields rose significantly during the period, providing a headwind for some interest-sensitive sectors.

The S&P 500 Index rose about 13% during the year ended February 28, 2018, driven primarily by solid earnings and recent legislation that lowered the corporate-tax rate. After three years of essentially flat earnings, the S&P 500 looks like it will have generated roughly 12% profit growth in 2017. The negative effect of a strong U.S. dollar and low oil prices, which depressed earnings in the Energy sector, started to wane a year ago and earnings growth has rebounded strongly. Profitability also remains exceptional as the top quintile of companies with the best profit margins are twice as profitable as the rest of the market. Market conditions have clearly changed since the turn of the year, but it is normal – even healthy – for the market to have two pullbacks and one or two corrections during a 12-month period.

“Our base-case assumption is that the U.S. economy continues to expand and that short-term interest rates rise slowly over the next year, but that stock volatility is likely to be markedly higher.”

Looking forward, our base-case assumption is that the U.S. economy continues to expand and that short-term interest rates rise slowly over the next year, but that stock volatility is likely to be markedly higher. The Fed is raising short-term interest rates, inflation is rising and earnings expectations and investor sentiment are high.

While rising asset prices, low corporate borrowing costs, falling energy prices and inflation as well as a weakening U.S. dollar are likely to turn into headwinds, the earnings cycle appears to be intact and credit markets remain supportive.

Europe

European equities remained fairly robust into the end of 2017 and rallied further during the early part of January 2018 before falling back. The MSCI Europe Index rose about 10% during

2017 in euro terms and 2018 offers prospects for further gains, albeit with a likely pickup in volatility. The economic expansion looks synchronized and robust, but the polarization of valuations in European markets will probably become an area of greater investor focus.

European populism is still a simmering risk, with nationalist inclinations in Eastern Europe, a messy recent election in Italy and significant uncertainty with regard to Brexit outcomes. At the market level, however, Europe still appears to offer value in absolute terms and, most especially, relative to the United States. We remain constructive on markets for 2018, but believe that the risks are higher than they were last year. As a result, we have reduced our long-term sector biases and have a more balanced approach than in the last several quarters.

Asia

Asia-Pacific markets managed to edge higher in the three-month period ended February 28, 2018, rebounding from a broad global stock sell-off in the wake of rising U.S. bond yields in late January. The resilience was due to confidence that the region’s earnings momentum will continue in 2018. The macroeconomic environment remains supportive of Asian equities given a weaker outlook for the U.S. dollar, relatively low commodity prices and a stable Chinese economy. Signs of synchronized global growth are a positive for export-dependent Asian markets and the lower U.S. dollar is a boon for liquidity in the region.

“The macroeconomic environment remains supportive of Asian equities given a weaker outlook for the U.S. dollar, relatively low commodity prices and a stable Chinese economy.”

For the first time in many years, China’s equity markets did not disappoint in 2017 in terms of corporate earnings growth. In fact, Chinese equities outperformed the regional benchmark, with a broad index of Hong Kong-listed Chinese companies adding about 18% in the three-month period ended February 28, 2018, as Beijing emphasizes a path of slower, but more sustainable growth in 2018. Underscoring the economy’s robust profits have been China’s decisions to depress interest rates and crack down on shadow banking and unregulated investments, all without crimping growth too much.

Emerging markets

In 2017, emerging-market equities had their best year since 2009, returning 37% in U.S.-dollar terms. Sustained outperformance was spurred by better fundamentals, attractive valuations in absolute and relative terms as well as attractive levels of trading for emerging-market currencies.

While economic growth has accelerated globally, emerging markets have experienced the strongest acceleration, aided by an improving political environment with crackdowns on corruption and significant reforms. The much-improved global macroeconomic environment since 2016 is now translating into better performance at the company level, including stronger returns on equity and increased earnings growth. Attractive valuations and currencies have also contributed to outperformance as equities in the region are currently trading at 1.8 times price-to-book value and at a 25% discount to developed markets, although this margin will likely

narrow as emerging countries move from cyclical plays to consumption-driven economies. Technical indicators support this positive performance as strong inflows lead to more buying. We estimate that at least another US\$100 billion will be invested into emerging-market equities in the coming months, potentially pushing markets higher.

There are, however, geopolitical and macroeconomic risks to our positive outlook. U.S. relationships with many large countries have deteriorated under Trump's administration and tensions with North Korea have the potential to re-escalate, despite receding recently. We are also watching for a significant slowdown in developed-world economic growth or a significant rise in inflation that causes central banks to tighten policy quickly to slow growth. Under those scenarios, we would likely see the U.S. dollar appreciate while emerging-market currencies and equities weaken.

This report has been provided by RBC Global Asset Management (RBC GAM) for informational purposes only and may not be reproduced, distributed or published without the written consent of RBC Global Asset Management Inc. (RBC GAM Inc.). In Canada, this report is provided by RBC GAM Inc. (including Phillips, Hager & North Investment Management). RBC GAM is the asset management division of Royal Bank of Canada (RBC) which includes RBC GAM Inc., RBC Global Asset Management (U.S.) Inc., RBC Global Asset Management (UK) Limited, RBC Investment Management (Asia) Limited, and BlueBay Asset Management LLP, which are separate, but affiliated subsidiaries of RBC. Any investment and economic outlook information contained in this report has been compiled by RBC GAM from various sources. Information obtained from third parties is believed to be reliable, but no representation or warranty, express or implied, is made by RBC GAM, its affiliates or any other person as to its accuracy, completeness or correctness. RBC GAM and its affiliates assume no responsibility for any errors or omissions.

All opinions contained within constitute our judgement as of March 15, 2018, are subject to change without notice, and are provided in good faith without legal responsibility. This report is not intended to provide legal, accounting, tax, investment, financial or other advice and such information should not be relied upon for providing such advice. The investment process as described in this report may change over time. The characteristics set forth in this report are intended as a general illustration of some of the criteria considered in selecting securities for client portfolios. Not all investments in a client portfolio will meet such criteria. RBC GAM takes reasonable steps to provide up-to-date, accurate and reliable information, and believes the information to be so when printed. RBC GAM reserves the right at any time and without notice to change, amend or cease publication of the information.

This report may contain forward-looking statements. The words "may", "could", "should", "would", "suspect", "outlook", "believe", "plan", "anticipate", "estimate", "expect", "intend", "forecast", "objective" and similar expressions are intended to identify forward-looking statements. Forward-looking statements are not guarantees of future performance. Forward-looking statements involve inherent risk and uncertainties, about the general economic factors, so it is possible that predictions, forecasts, projections and other forward-looking statements will not be achieved.

® / ™ Trademark(s) of Royal Bank of Canada. Used under licence.
© RBC Global Asset Management Inc. 2018

