THE GLOBAL INVESTMENT OUTLOOK

RBC GAM Investment Strategy Committee

SUMMER 2017

Global Asset Management

THE RBC GAM INVESTMENT STRATEGY COMMITTEE

The RBC GAM Investment Strategy Committee consists of senior investment professionals drawn from across RBC Global Asset Management. The Committee regularly receives economic and capital markets related input from internal and external sources. Important guidance is provided by the Committee's regional advisors (North America, Europe, Far East), from the Global Fixed Income & Currencies Subcommittee and from the global equity sector heads (financials and healthcare, consumer discretionary and consumer staples, industrials and utilities, energy and materials, telecommunications and technology). From this it builds a detailed global investment forecast looking one year forward.

The Committee's view includes an assessment of global fiscal and monetary conditions, projected economic growth and inflation, as well as the expected course of interest rates, major currencies, corporate profits and stock prices.

From this global forecast, the RBC GAM Investment Strategy Committee develops specific guidelines that can be used to manage portfolios.

These include:

- the recommended mix of cash, fixed income instruments, and equities
- the recommended global exposure of fixed income and equity portfolios
- the optimal term structure for fixed income investments
- the suggested sector and geographic make-up within equity portfolios
- the preferred exposure to major currencies

Results of the Committee's deliberations are published quarterly in *The Global Investment Outlook*.

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EXECUTIVE SUMMARY

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The economic uptick that took root in the summer of 2016 has continued to bloom and a synchronized global economic expansion is at hand, with leading indicators pointing to a faster-than-normal clip across much of the world. That said, the initial acceleration phase has arguably come to an end and, as a result, risk assets are still rising, but with less vim than at the turn of the year.

Delaying and diluting impact of Trump initiatives

The election of Donald Trump last autumn was a catalyst for financial markets, with sizeable implications for fiscal and foreign policy. However, expectations for major public policy changes under the new U.S. president have dimmed somewhat as the political landscape proves more difficult to navigate than initially anticipated. Accordingly, we now look for delayed policy action and diluted economic implications, with the net effect being slightly less negative for the long-run economy.

Growth signals appear to have peaked

We have slightly downgraded our 2017 developed-world growth forecast, but modestly upgraded the 2018 outlook. Most of this adjustment is the result of changes in the U.S. due to the delayed expectation of fiscal stimulus from 2017 to 2018. Canada and Japan have also enjoyed 2017 growth upgrades as they have been managing a particularly sprightly economic acceleration. In the end, we budget for a bit more economic growth over the next few years than was managed over the past several. However, we must not forget that there are still plenty of reasons why the sustainable growth rate is notably lower than it was a decade or two ago, and these are rooted in deteriorating demographics and a changing economic structure. Emerging-market economies collectively suffered through a multi-year period of decelerating economic growth, before righting themselves in recent years. We have upgraded our emerging-market growth forecast slightly for both 2017 and 2018, though these remain a bit below the consensus.

Downside risks remain but appear manageable

As is always the case, downside risks abound. The top three in our minds are the threat of protectionism, an aging business cycle and precarious international relations. Protectionism is a central risk given the rise of populism and the isolationist foundation that girds the movement. The aging business cycle also continues to merit careful tracking. Nothing whatsoever points to an imminent recession, but the risk is not trivial over the next few years. Finally, while past geopolitical risks have rarely had a large effect on markets, there is growing uncertainty around U.S. foreign policy and the nuclear capabilities that North Korea appears to be on the cusp of achieving, and these are not risks to be trifled with.

U.S. dollar bull market remains intact

Our currency outlook remains tilted toward appreciation of the U.S. dollar versus other major developed-market currencies. While this has been our stance for several years, our message is now more nuanced. We are more cautious than we have been due to the maturing U.S. dollar cycle and the possibility that dollar-negative factors are playing a larger role. There remain, however, valid reasons why this cycle could extend beyond the average, and they don't require heroic assumptions about dollar-friendly Trump policies. Growth differentials;

a benign current account deficit, especially given the stage of the recovery; monetary policy divergences and only moderate overvaluation are among the reasons for staying bullish on the U.S. dollar.

Inflation to take a breather

Inflation has made a giant leap forward over the past year, exiting a multi-year period of deflation fears in favour of a somewhat more normal inflation environment. Having accelerated from rock-bottom to slightly low levels, inflation readings are now set to go mostly sideways over the next few quarters. This recognition has prompted us to slightly downgrade our 2017 inflation forecasts, leaving them a bit below the consensus. We persist in an above-consensus inflation outlook for 2018 and beyond as the business cycle ratchets tighter, helping to bring core inflation readings up to the standard of headline inflation.

Central banks leaning towards tighter monetary policy

In response to improving economies, central banks are leaning toward tighter monetary policy. The underlying motivation for this pivot is primarily that inflation readings are no longer quite so low and that economies appear to have achieved significant progress toward their full potential. The Fed, the world's bellwether central bank, is again setting the pace with a handful of rate increases already delivered, and more on offer. The Fed also plans to begin scaling back the size of its balance sheet toward the end of the year. Among other central banks, China has also been raising rates, though for more home-grown debt-related reasons. The Bank of Canada has stopped musing about rate cuts, the Bank of England seems content to allow its current round of quantitative easing to fade while the European Central Bank has already tapered its pace of bond buying slightly, though it is in no hurry to unwind its balance sheet.

Recent decline in bond yields reintroduces valuation risk

Global bond yields have drifted lower in the last quarter as enthusiasm about Trump's pro-growth policies has receded. The resulting drop in nominal bond yields has reintroduced the valuation risk that had mostly evaporated during the initial run-up after Trump's election. Although the trend so far this year has been towards lower bond yields, our models continue to suggest that the long-term direction of yields is higher. That said, a number of structural headwinds – aging populations, a limited capacity to take on debt, wealth inequality, globalization and a preference for safe assets – may limit the pace of the increase in bond yields. Our forecast for the U.S. 10-year yield is 2.50% a year out, and any deviation from our base case would likely be to the upside.

Stocks extend gains, earnings outlook brightens

The combination of a synchronized global expansion and an acceleration in corporate-profit growth has lifted global equities to new highs, driving valuations higher. While we recognize that stocks are nowhere near as cheap as they were when the bull market began eight years ago, equities in Canada, Europe and emerging markets all remain attractively priced. On a relative basis, the U.S. equity market has the fullest valuations, having recovered significantly from the depths of the financial crisis. As a result, improving valuations may no longer be a driving force for U.S. stocks and further gains will likely need to come from increasing corporate profits. Fortunately for equity investors, corporate profits have recovered from their two-year swoon and are now growing at their fastest pace of the post-crisis era. Therefore, it is not unreasonable to expect further gains in equities and, if profits rise as analysts expect, the total-return potential for stocks is still quite positive.

Trimming equity overweight

With modest growth in the economy and decent inflation, the outlook for sovereign fixed-income investments is unexciting. At current yields, prospective returns for bonds are extremely low or even negative. As a result, we remain underweight fixed income in our asset mix. While prospective long-term returns for equities are much better than for bonds, key signals have prompted us to modify our degree of enthusiasm for stocks. Having harvested the stock market's outsized gains that resulted from the recent economic acceleration, we have begun to scale back our risk-taking by reducing our allocation to equities. This is further motivated by the ongoing maturation of the business cycle, by equity valuations that are becoming less compelling and concern that complacency is beginning to seep into markets. The tweak leaves our equity overweight intact, however. For a balanced, global investor, we currently recommend an asset mix of 59% equities (strategic neutral position: 55%) and 38% fixed income (strategic neutral position: 43%), with the balance in cash.

ECONOMIC & CAPITAL MARKETS FORECASTS

ECONOMIC FORECAST (RBC GAM INVESTMENT STRATEGY COMMITTEE)

	UNITED STATES		CANADA		EUROPE		UNITED KINGDOM		JAPAN		CHINA		EMERGING MARKETS*	
	Summer 2017	Change from Spring 2017	Summer 2017	Change from Spring 2017	Summer 2017	Change from Spring 2017	Summer 2017	Change from Spring 2017	Summer 2017	Change from Spring 2017	Summer 2017	Change from Spring 2017	Summer 2017	Change from Spring 2017
REAL GDP														
2016A	1.60%		1.43%		1.68%		1.85%		0.99%		6.73%		4.99%	
2017E	2.00%	(0.25)	2.00%	0.50	1.75%	N/C	1.75%	N/C	1.25%	0.50	6.50%	0.25	5.25%	N/C
2018E	2.50%	0.25	1.50%	N/C	1.50%	N/C	1.50%	N/C	0.75%	N/C	5.75%	N/C	5.25%	N/C
CPI														
2016A	1.28%		1.41%		0.25%		0.65%		0.77%		2.12%		3.66%	
2017E	2.50%	N/C	1.75%	(0.25)	1.75%	N/C	2.25%	(0.75)	0.75%	(0.25)	2.00%	(0.50)	3.00%	(0.50)
2018E	2.25%	N/C	2.25%	N/C	1.75%	N/C	2.75%	N/C	1.25%	0.25	2.50%	N/C	3.50%	0.25

A = Actual E = Estimate *GDP Weighted Average of China, India, South Korea, Brazil, Mexico and Russia.

TARGETS (RBC GAM INVESTMENT STRATEGY COMMITTEE)

	MAY 2017	FORECAST MAY 2018	CHANGE FROM SPRING 2017	1-YEAR TOTAL RETURN ESTIMATE* (%)
CURRENCY MARKETS AGAINST USD				
CAD (USD–CAD)	1.35	1.44	N/C	(6.7)
EUR (EUR–USD)	1.12	1.02	0.02	(10.7)
JPY (USD–JPY)	110.75	115.00	N/C	(5.0)
GBP (GBP–USD)	1.29	1.15	N/C	(11.6)
FIXED INCOME MARKETS				
U.S. Fed Funds Rate	1.00	1.63	0.25	N/A
U.S. 10-Year Bond	2.21	2.50	N/C	(0.3)
Canada Overnight Rate	0.50	0.75	0.25	N/A
Canada 10-Year Bond	1.42	1.75	N/C	(1.6)
Eurozone Deposit Facility Rate	-0.40	-0.40	N/C	N/A
Germany 10-Year Bund	0.30	0.75	N/C	(4.0)
U.K. Base Rate	0.25	0.25	N/C	N/A
U.K. 10-Year Gilt	1.05	1.25	(0.25)	(0.9)
Japan Overnight Call Rate	-0.07	-0.10	N/C	N/A
Japan 10-Year Bond	0.05	0.10	N/C	(0.5)
EQUITY MARKETS				
S&P 500	2412	2550	25	7.7
S&P/TSX Composite	15350	16100	(25)	7.8
MSCI Europe	132	142	7	11.3
FTSE 100	7511	7850	300	8.6
Nikkei	19651	21250	1275	10.0
MSCI Emerging Markets	1005	1075	75	9.5

*Total returns are expressed in local currencies with the exception of MSCI Emerging Markets whose return is expressed in USD. Source: RBC GAM

RECOMMENDED ASSET MIX

Asset mix – the allocation within portfolios to stocks, bonds and cash – should include both strategic and tactical elements. Strategic asset mix addresses the blend of the major asset classes offering the risk/return tradeoff best suited to an investor's profile. It can be considered to be the benchmark investment plan that anchors a portfolio through many business and investment cycles, independent of a near-term view of the prospects for the economy and related expectations for capital markets. Tactical asset allocation refers to fine tuning around the strategic setting in an effort to add value by taking advantage of shorter term fluctuations in markets.

Every individual has differing return expectations and tolerances for volatility, so there is no "one size fits all" strategic asset mix. Based on a 40-year study of historical returns[1] and the volatility[2] of returns (the range around the average return within which shorter-term results tend to fall), we have developed five broad profiles and assigned a benchmark strategic asset mix for each. These profiles range from very conservative through balanced to aggressive growth. It goes without saying that as investors accept increasing levels of volatility, and therefore greater risk that the actual experience will depart from the longer-term norm, the potential for returns rises. The five profiles presented below may assist investors in selecting a strategic asset mix best aligned to their investment goals.

Each quarter, the RBC GAM Investment Strategy Committee publishes a recommended asset mix based on our current view of the economy and return expectations for the major asset classes. These weights are further divided into recommended exposures to the variety of global fixed income and equity markets. Our recommendation is targeted at the Balanced profile where the benchmark setting is 55% equities, 43% fixed income, 2% cash.

A tactical range of +/- 15% around the benchmark position allows us to raise or lower exposure to specific asset classes with a goal of tilting portfolios toward those markets that offer comparatively attractive near-term prospects.

This tactical recommendation for the Balanced profile can serve as a guide for movement within the ranges allowed for all other profiles.

The value-added of tactical strategies is, of course, dependent on the degree to which the expected scenario unfolds.

Regular reviews of portfolio weights are essential to the ultimate success of an investment plan as they ensure current exposures are aligned with levels of long-term returns and risk tolerances best suited to individual investors.

Anchoring portfolios with a suitable strategic asset mix, and placing boundaries defining the allowed range for tactical positioning, imposes discipline that can limit damage caused by swings in emotion that inevitably accompany both bull and bear markets.

1. **Average return:** The average total return produced by the asset class over the period 1977 – 2017, based on monthly results.
2. **Volatility:** The standard deviation of returns. Standard deviation is a statistical measure that indicates the range around the average return within which 2/3 of results will fall into, assuming a normal distribution around the long-term average.

GLOBAL ASSET MIX

	BENCHMARK POLICY	PAST RANGE	SUMMER 2016	FALL 2016	NEW YEAR 2017	SPRING 2017	SUMMER 2017
CASH	**2.0%**	1.0% – 16%	3.0%	3.0%	1.0%	2.0%	**3.0%**
BONDS	**43.0%**	25.0% – 54.0%	37.0%	37.0%	38.0%	38.0%	**38.0%**
STOCKS	**55.0%**	36.0% – 65.0%	60.0%	60.0%	61.0%	60.0%	**59.0%**

Note: Effective September 1, 2014, we revised our strategic neutral positions within fixed income, lowering the 'neutral' commitment to cash from 5% to 2%, and moving the difference to bonds. This takes advantage of the positive slope of the yield curve which prevails over most time periods, and allows our fixed income managers to shorten duration and build cash reserves whenever a correction in the bond market, or especially an inverted yield curve, is anticipated.

REGIONAL ALLOCATION

GLOBAL BONDS	CWGBI* MAY 2017	PAST RANGE	SUMMER 2016	FALL 2016	NEW YEAR 2017	SPRING 2017	SUMMER 2017
North America	**39.3%**	18% – 44%	37.0%	36.9%	38.1%	44.2%	**44.3%**
Europe	**39.1%**	32% – 56%	35.3%	34.4%	33.5%	36.4%	**34.1%**
Asia	**21.6%**	17% – 35%	27.7%	28.8%	28.4%	19.5%	**21.6%**

Note: Past Range reflects historical allocation from Fall 2002 to present.

GLOBAL EQUITIES	MSCI** MAY 2017	PAST RANGE	SUMMER 2016	FALL 2016	NEW YEAR 2017	SPRING 2017	SUMMER 2017
North America	**61.0%**	51% – 61%	60.2%	60.0%	60.3%	60.8%	**59.9%**
Europe	**20.7%**	20% – 35%	21.6%	20.5%	20.3%	20.3%	**21.3%**
Asia	**11.0%**	9% – 18%	10.8%	12.0%	11.9%	11.4%	**11.4%**
Emerging Markets	**7.3%**	0% – 8.5%	7.5%	7.5%	7.5%	7.5%	**7.5%**

Our asset mix is reported as at the end of each quarter. The mix is fluid and may be adjusted within each quarter, although we do not always report on shifts as they occur. The weights in the table should be considered a snapshot of our asset mix at the date of release of the *Global Investment Outlook*.

GLOBAL EQUITY SECTOR ALLOCATION

	MSCI** MAY 2017	RBC GAM ISC SPRING 2017	RBC GAM ISC SUMMER 2017	CHANGE FROM SPRING 2017	WEIGHT VS. BENCHMARK
Energy	6.29%	5.95%	4.49%	(1.46)	71.4%
Materials	4.98%	5.20%	5.78%	0.58	116.1%
Industrials	11.42%	13.21%	13.42%	0.21	117.5%
Consumer Discretionary	12.48%	14.31%	14.48%	0.16	116.0%
Consumer Staples	9.80%	9.69%	9.80%	0.11	100.0%
Health Care	12.29%	12.03%	14.29%	2.26	116.3%
Financials	17.66%	18.08%	15.66%	(2.42)	88.7%
Information Technology	15.71%	17.03%	17.71%	0.68	112.7%
Telecom. Services	3.02%	1.23%	1.02%	(0.21)	33.8%
Utilities	3.17%	1.09%	2.07%	0.98	65.3%
Real Estate	3.19%	2.16%	1.29%	(0.87)	40.5%

*Citigroup World Global Bond Index **MSCI World Index

Source: RBC GAM Investment Strategy Committee

At RBC GAM, we have a team dedicated to setting and reviewing the strategic asset mix for all of our multi-asset solutions. With an emphasis on consistency of returns, risk management and capital preservation, we have developed a strategic asset allocation framework for five client risk profiles that correspond to broad investor objectives and risk preferences. These five profiles range from Very Conservative through Balanced to Aggressive Growth.

VERY CONSERVATIVE

ASSET CLASS	BENCH-MARK	RANGE	LAST QUARTER	CURRENT RECOMMENDATION
Cash & Cash Equivalents	2%	0-15%	2.0%	2.9%
Fixed Income	78%	55-95%	73.7%	73.3%
Total Cash & Fixed Income	80%	65-95%	75.7%	76.2%
Canadian Equities	10%	5-20%	11.2%	11.0%
U.S. Equities	5%	0-10%	6.8%	6.0%
International Equities	5%	0-10%	6.3%	6.8%
Emerging Markets	0%	0%	0.0%	0.0%
Total Equities	20%	5-35%	24.3%	23.8%

	RETURN	VOLATILITY
40-Year Average	8.9%	5.5%
Last 12 Months	5.5%	2.8%

Very Conservative investors will seek income with maximum capital preservation and the potential for modest capital growth, and be comfortable with small fluctuations in the value of their investments. This portfolio will invest primarily in fixed-income securities, and a small amount of equities, to generate income while providing some protection against inflation. Investors who fit this profile generally plan to hold their investment for the short to medium term (minimum one to five years).

CONSERVATIVE

ASSET CLASS	BENCH-MARK	RANGE	LAST QUARTER	CURRENT RECOMMENDATION
Cash & Cash Equivalents	2%	0-15%	2.0%	2.9%
Fixed Income	63%	40-80%	58.3%	58.2%
Total Cash & Fixed Income	65%	50-80%	60.3%	61.1%
Canadian Equities	15%	5-25%	16.3%	16.0%
U.S. Equities	10%	0-15%	12.0%	11.0%
International Equities	10%	0-15%	11.4%	11.9%
Emerging Markets	0%	0%	0.0%	0.0%
Total Equities	35%	20-50%	39.7%	38.9%

	RETURN	VOLATILITY
40-Year Average	9.2%	6.5%
Last 12 Months	7.6%	2.8%

Conservative investors will pursue modest income and capital growth with reasonable capital preservation, and be comfortable with moderate fluctuations in the value of their investments. The portfolio will invest primarily in fixed-income securities, with some equities, to achieve more consistent performance and provide a reasonable amount of safety. The profile is suitable for investors who plan to hold their investment over the medium to long term (minimum five to seven years).

BALANCED

ASSET CLASS	BENCH-MARK	RANGE	LAST QUARTER	CURRENT RECOMMENDATION
Cash & Cash Equivalents	2%	0-15%	2.0%	3.0%
Fixed Income	43%	20-60%	38.0%	38.0%
Total Cash & Fixed Income	45%	30-60%	40.0%	41.0%
Canadian Equities	19%	10-30%	20.2%	19.9%
U.S. Equities	20%	10-30%	21.9%	20.9%
International Equities	12%	5-25%	13.4%	13.8%
Emerging Markets	4%	0-10%	4.5%	4.4%
Total Equities	55%	40-70%	60.0%	59.0%

	RETURN	VOLATILITY
40-Year Average	9.5%	7.7%
Last 12 Months	11.1%	3.2%

The **Balanced** portfolio is appropriate for investors seeking balance between long-term capital growth and capital preservation, with a secondary focus on modest income, and who are comfortable with moderate fluctuations in the value of their investments. More than half the portfolio will usually be invested in a diversified mix of Canadian, U.S. and global equities. This profile is suitable for investors who plan to hold their investment for the medium to long term (minimum five to seven years).

GROWTH

ASSET CLASS	BENCH-MARK	RANGE	LAST QUARTER	CURRENT RECOMMENDATION
Cash & Cash Equivalents	2%	0-15%	2.0%	3.0%
Fixed Income	28%	5-40%	22.6%	22.9%
Total Cash & Fixed Income	30%	15-45%	24.6%	25.9%
Canadian Equities	23%	15-35%	24.4%	23.9%
U.S. Equities	25%	15-35%	26.9%	25.9%
International Equities	16%	10-30%	17.5%	17.8%
Emerging Markets	6%	0-12%	6.6%	6.5%
Total Equities	70%	55-85%	75.4%	74.1%

	RETURN	VOLATILITY
40-Year Average	9.7%	9.4%
Last 12 Months	13.6%	3.6%

Investors who fit the **Growth** profile will seek long-term growth over capital preservation and regular income, and be comfortable with considerable fluctuations in the value of their investments. This portfolio primarily holds a diversified mix of Canadian, U.S. and global equities and is suitable for investors who plan to invest for the long term (minimum seven to ten years).

AGGRESSIVE GROWTH

ASSET CLASS	BENCH-MARK	RANGE	LAST QUARTER	CURRENT RECOMMENDATION
Cash & Cash Equivalents	2%	0-15%	1.0%	2.0%
Fixed Income	0%	0-10%	0.0%	0.0%
Total Cash & Fixed Income	2%	0-20%	1.0%	2.0%
Canadian Equities	32.5%	20-45%	32.3%	32.0%
U.S. Equities	35.0%	20-50%	35.9%	34.5%
International Equities	21.5%	10-35%	21.5%	22.3%
Emerging Markets	9.0%	0-15%	9.3%	9.2%
Total Equities	98%	80-100%	99.0%	98.0%

	RETURN	VOLATILITY
40-Year Average	10.3%	12.1%
Last 12 Months	18.2%	4.7%

Aggressive Growth investors seek maximum long-term growth over capital preservation and regular income, and are comfortable with significant fluctuations in the value of their investments. The portfolio is almost entirely invested in stocks and emphasizes exposure to global equities. This investment profile is suitable only for investors with a high risk tolerance and who plan to hold their investments for the long term (minimum seven to ten years).

CAPITAL MARKETS PERFORMANCE

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The U.S. dollar depreciated against the euro, the yen and the British pound during the three-month period ended May 31, 2017, while rising against the Canadian dollar. The decline in the greenback was 5.7% versus the euro, 3.7% versus sterling and 1.4% against the yen. The U.S. dollar rose 1.7% against the Canadian dollar. For the latest 12-month period, the U.S. dollar climbed 12.4% versus sterling, extending its revaluation versus the British currency since the U.K.'s decision in June 2016 to leave the EU, and 3.0% against the Canadian dollar. However, the U.S. dollar lost ground versus the euro, falling 1.0%, and was essentially unchanged against the yen.

Global bond markets recorded gains during the latest three-month period, continuing their rebound from losses following Donald Trump's November election as U.S. president. The Barclays Capital Aggregate Bond Index, a broad measure of U.S. fixed-income performance, gained 1.5%, while European bonds returned 6.1% as measured by the Citigroup WGBI – Europe Index. European bonds rallied after pro-Europe candidate Emmanuel Macron won last month's French presidential election. The Citigroup Japanese Government Bond Index gained 1.7%, and the FTSE TMX Canada Universe Bond Index, Canada's fixed-income benchmark, returned 1.0% in U.S. dollar terms.

Global equity markets recorded gains during the three-month period led in part by large-cap technology stocks, as the outlook for the global economy and earnings growth improved. The S&P 500 Index rose 2.6% and the MSCI Japan gained 3.7%. The MSCI Germany climbed 12.3%, while the MSCI U.K. returned 8.6% and the MSCI France gained 17.5%, all in U.S. dollar terms. Over the 12-month period, the S&P 500 gained 17.5% and the MSCI Japan rose 15.0%. In Europe, the MSCI Germany returned 22.7%, the MSCI France gained 22.2% and the MSCI U.K. returned 11.4%, all in U.S. dollar terms. The S&P/TSX Composite Index lost 1.3% in U.S. dollar terms during the three months, compared with a 1.1% loss for the large-cap S&P/TSX 60 Index and a 6.6% loss for the S&P/TSX Small Cap Index. For the 12-month period, the S&P/TSX benchmark index gained 9.0%. The MSCI Emerging Markets Index returned 7.9% during the three-month period and gained 27.4% over the 12-month period, both in U.S. dollar terms.

The S&P 400 Index, a measure of the U.S. mid-cap market, was flat in the latest three-month period and rose 17.2% in the 12-month period, while the S&P 600 Index, a gauge of small-cap performance, lost 1.4% in the three-month period but gained 19.6% in the 12-month period. The Russell 3000 Growth Index gained 5.9% during the quarter versus a 1.5% loss for the Russell 3000 Value Index. Over the 12 months, the Russell 3000 Growth Index gained 20.2%, while the Russell 3000 Value Index returned 15.1%.

All but one of the 11 global equity sectors recorded gains during the quarter ended May 31, 2017. The best-performing sector was Information Technology with a return of 10.1%, followed by Utilities, which rose 8.5% and Consumer Staples with a 7.3% increase. The worst-performing sector over the three-month period was Energy, which fell 3.5%. Over the 12-month period, the best-performing sectors were Information Technology, Materials and Financials, and the worst-performing were Telecommunication Services, Energy and Health Care.

EXCHANGE RATES
Periods ending May 31, 2017

	Current USD	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)
USD–CAD	1.3509	1.71	0.61	3.01	7.60	5.51
USD–EUR	0.8902	(5.69)	(6.29)	(0.95)	6.66	1.93
USD–GBP	0.7761	(3.69)	(4.35)	12.41	9.17	3.64
USD–JPY	110.7500	(1.42)	(5.24)	0.01	2.85	7.17

Note: all changes above are expressed in US dollar terms

CANADA
Periods ending May 31, 2017

	USD					CAD		
Fixed Income Markets: Total Return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	3 months (%)	1 year (%)	3 years (%)
FTSE TMX Canada Univ. Bond Index TR	1.00	2.95	(0.02)	(3.08)	(1.87)	2.72	2.99	4.29

U.S.
Periods ending May 31, 2017

	USD					CAD		
Fixed Income Markets: Total Return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	3 months (%)	1 year (%)	3 years (%)
Citigroup U.S. Government TR	1.55	2.46	1.64	2.55	2.25	3.28	4.70	10.34
Barclays Capital Agg. Bond Index TR	1.49	2.38	1.58	2.53	2.24	3.22	4.64	10.32

GLOBAL
Periods ending May 31, 2017

	USD					CAD		
Fixed Income Markets: Total Return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	3 months (%)	1 year (%)	3 years (%)
Citigroup WGBI TR	3.08	4.34	0.70	(0.09)	0.96	4.84	3.73	7.50
Citigroup European Government TR	6.11	6.36	(0.30)	(2.50)	2.65	7.92	2.70	4.90
Citigroup Japanese Government TR	1.68	5.41	(2.64)	(0.10)	(4.43)	3.41	0.29	7.49

CANADA
Periods ending May 31, 2017

	USD					CAD		
Equity Markets: Total Return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	3 months (%)	1 year (%)	3 years (%)
S&P/TSX Composite	(1.25)	0.88	8.99	(2.67)	3.44	0.43	12.27	4.73
S&P/TSX 60	(1.05)	1.19	10.32	(1.66)	4.19	0.64	13.64	5.82
S&P/TSX Small Cap	(6.62)	(5.16)	5.52	(6.62)	(0.89)	(5.03)	8.70	0.48

U.S.
Periods ending May 31, 2017

	USD					CAD		
Equity Markets: Total Return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	3 months (%)	1 year (%)	3 years (%)
S&P 500 TR	2.57	8.66	17.47	10.14	15.42	4.32	21.01	18.50
S&P 400 TR	(0.04)	4.30	17.16	9.42	14.98	1.66	20.69	17.73
S&P 600 TR	(1.37)	(0.19)	19.63	9.93	15.74	0.32	23.23	18.28
Russell 3000 Value TR	(1.48)	2.50	15.12	7.66	14.59	0.20	18.59	15.85
Russell 3000 Growth TR	5.86	13.68	20.23	11.66	15.86	7.67	23.85	20.15
NASDAQ Composite Index TR	6.40	15.15	25.27	13.47	17.00	8.22	29.05	22.09

Note: all rates of return presented for periods longer than 1 year are annualized

Source: Bloomberg/MSCI

GLOBAL
Periods ending May 31, 2017

	USD					CAD		
Equity Markets: Total Return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	3 months (%)	1 year (%)	3 years (%)
MSCI World TR *	4.73	10.23	16.42	5.73	12.41	6.81	20.21	13.71
MSCI EAFE TR *	9.23	14.01	16.44	1.53	10.21	11.40	20.23	9.19
MSCI Europe TR *	12.91	16.63	17.00	0.09	10.73	15.15	20.81	7.65
MSCI Pacific TR *	3.15	9.58	16.01	4.60	9.42	5.19	19.79	12.50
MSCI UK TR *	8.57	12.17	11.44	(2.12)	7.15	10.73	15.07	5.27
MSCI France TR *	17.46	18.59	22.23	1.76	12.88	19.79	26.21	9.44
MSCI Germany TR *	12.28	16.53	22.66	1.08	12.38	14.50	26.65	8.70
MSCI Japan TR *	3.71	8.77	15.02	6.97	10.43	5.76	18.77	15.04
MSCI Emerging Markets TR *	7.87	17.25	27.41	1.62	4.54	10.00	31.56	9.29

GLOBAL EQUITY SECTORS
Periods ending May 31, 2017

	USD					CAD		
Sector: Total Return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	3 months (%)	1 year (%)	3 years (%)
Energy TR *	(3.52)	(8.41)	3.99	(10.00)	1.00	(1.61)	7.38	(3.21)
Materials TR *	2.02	8.16	21.93	0.79	5.36	4.04	25.90	8.39
Industrials TR *	6.05	11.92	20.32	6.69	13.58	8.15	24.24	14.74
Consumer Discretionary TR *	7.03	12.11	16.96	8.45	15.27	9.15	20.77	16.63
Consumer Staples TR *	7.30	13.84	10.33	7.68	12.11	9.42	13.92	15.81
Health Care TR *	4.44	12.90	7.78	6.95	15.68	6.51	11.29	15.03
Financials TR *	0.49	5.20	21.23	4.76	13.82	2.48	25.18	12.67
Information Technology TR *	10.09	20.51	32.70	15.96	17.33	12.27	37.02	24.72
Telecommunication Services TR *	2.79	3.33	2.01	2.28	9.50	4.83	5.33	10.00
Utilities TR *	8.53	13.69	11.58	4.95	9.14	10.68	15.22	12.87
Real Estate TR *	2.41	7.24	NA	NA	NA	4.44	NA	NA

* Net of taxes   Note: all rates of return presented for periods longer than 1 year are annualized   Source: Bloomberg/MSCI

GLOBAL INVESTMENT OUTLOOK

Synchronized expansion continues

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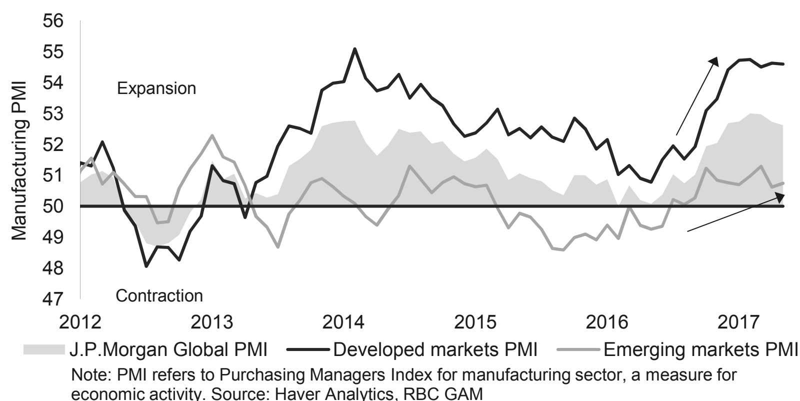
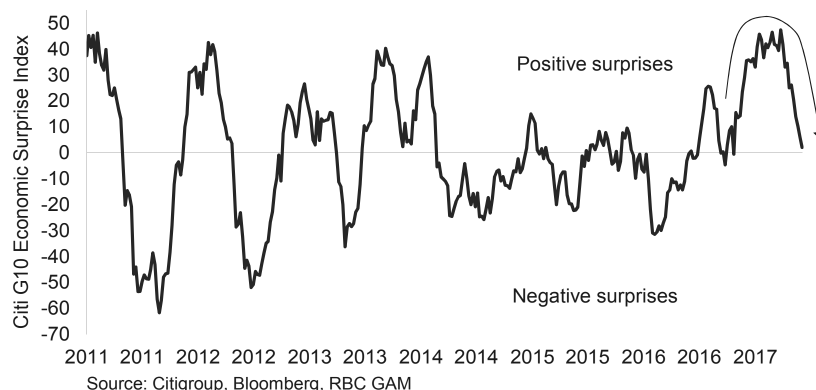
Exhibit 1: Global manufacturing continues to expand



Note: PMI refers to Purchasing Managers Index for manufacturing sector, a measure for economic activity. Source: Haver Analytics, RBC GAM

Exhibit 2: Economic surprises reverse course



Source: Citigroup, Bloomberg, RBC GAM

The synchronized global economic expansion continues, with leading indicators pointing to a faster-than-normal clip across much of the world (Exhibit 1). That said, the initial acceleration phase has arguably come to an end (Exhibit 2). As a result, risk assets are still rising, but with less vim than at the turn of the year.

Expectations for major public policy changes under a new U.S. president have dimmed somewhat as the political landscape proves more difficult to navigate than initially anticipated. Fortunately, this was not the only factor supporting improved growth – several other drivers remain.

In response to improving economies, central banks are leaning toward tighter monetary policy. The U.S. Federal Reserve (Fed) has led the way, with more action still to come. This represents the tentative beginning of a less stimulative era, but we believe economies are well positioned to withstand the change. Logically, bond yields have increased over the past year in response to this narrative of tighter central-bank policy combined with higher inflation.

Having harvested the stock market's outsized gains that resulted from the recent economic acceleration, we have since marginally scaled back our risk-taking by reducing our allocation to equities. This is further motivated by the ongoing maturation of the business cycle, by equity valuations that are becoming less compelling and our concern about growing complacency in markets (Exhibit 3). The tweak leaves our equity overweight intact, however.

Growth signals peak

The economic uptick that took root in the summer of 2016 has continued to bloom. Leading indicators remain consistent with solid growth of the sort not regularly achieved during the post-crisis period (Exhibit 4).

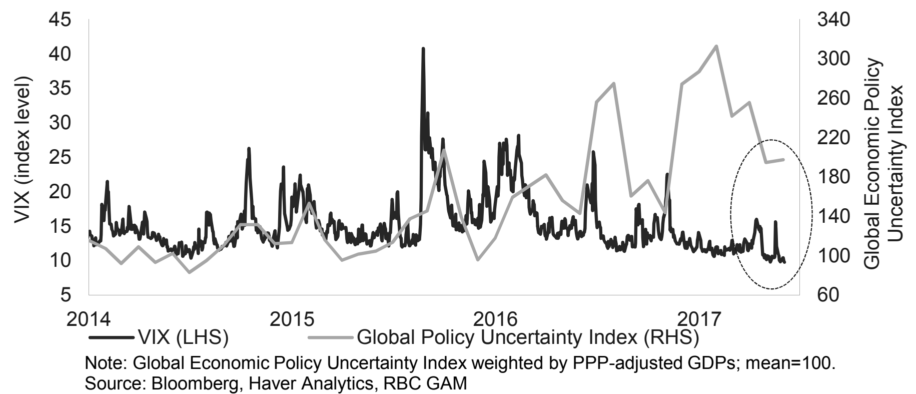
There are a number of plausible reasons for this stretch of superior growth:

- A natural bounce after the economic swoon from late 2015 through mid-2016 (Exhibit 5)
- The lagged effect of past monetary stimulus
- Positive spillover from an accelerating Chinese economy
- Optimism in response to the U.S. election
- The fading gravitational pull of the financial crisis

The last of these drivers may have staying power and the U.S. election boost won't peak until 2018, but the rest should fade with time. The global credit impulse is already becoming a bit less helpful (Exhibit 6). Alongside tentative evidence that various macro signals are already peaking, we suspect the acceleration phase of this mini-cycle has come to an end. In fact, we budget for a slight deceleration from recent robust figures over the remainder of 2017.

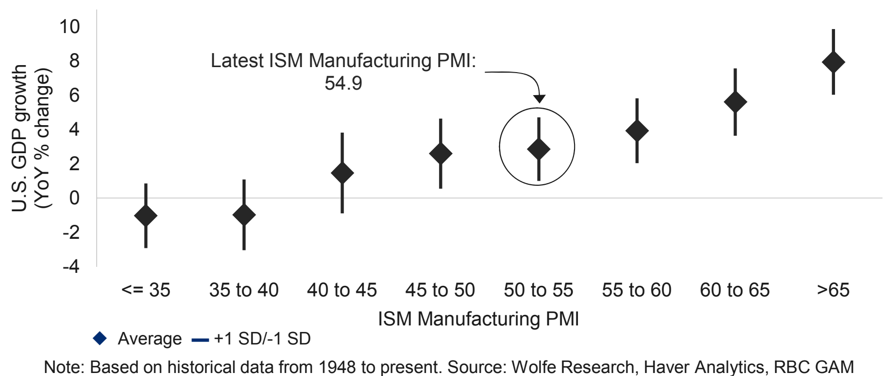
A criticism of recent rosy economic data is that it is disproportionately concentrated in "soft" survey-based measures as opposed to "hard" metrics of actual economic activity. There is some truth to this (Exhibit 7), and alas it is the hard data that is ultimately more important. Fortunately, soft data should theoretically lead hard data, so there is hope that activity metrics will stage a further improvement.

Exhibit 3: VIX and policy uncertainty disagree



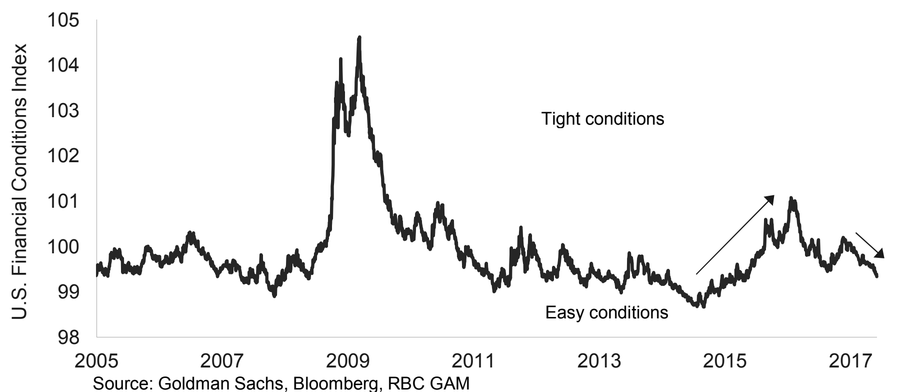
Note: Global Economic Policy Uncertainty Index weighted by PPP-adjusted GDPs; mean=100. Source: Bloomberg, Haver Analytics, RBC GAM

Exhibit 4: U.S. manufacturing a bellwether for GDP growth



Note: Based on historical data from 1948 to present. Source: Wolfe Research, Haver Analytics, RBC GAM

Exhibit 5: Financial conditions eased after U.S. election



Source: Goldman Sachs, Bloomberg, RBC GAM

Furthermore, the most important piece of hard data for investors is surely corporate earnings, which have rebounded forcefully and widely – with additional improvements expected (Exhibit 8).

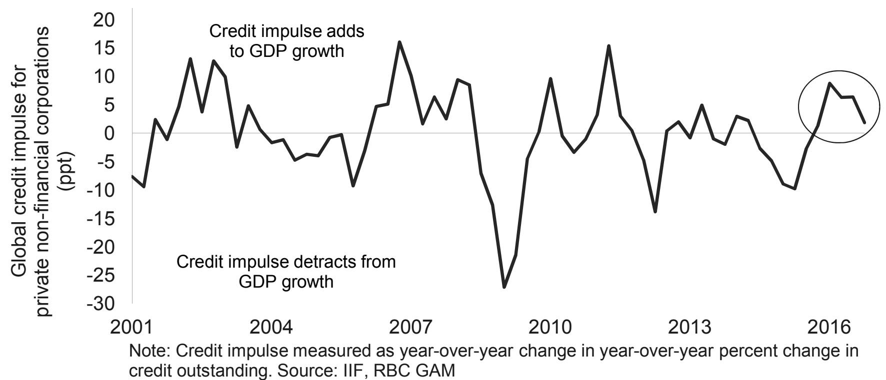
We have slightly downgraded our 2017 developed-world growth forecast, but modestly upgraded the 2018 outlook. Most of this adjustment is the result of U.S. changes due to the delayed expectation of fiscal stimulus from 2017 to 2018. Canada and Japan have also enjoyed 2017 growth upgrades as they have been managing a particularly sprightly economic acceleration.

This leaves developed-world growth running at a slightly faster clip in 2017 than the year before, with scope for a further slight acceleration in 2018 (Exhibit 9). We tilt a little below the consensus forecast for both years, cognizant that growth has disappointed expectations in the post-crisis era. That said, our conservative stance masks a diverse set of views at the national level, with below-consensus forecasts for Canada and Japan despite their recent upgrades, versus a slightly above-consensus U.K. forecast. The U.S. and European economies look set to broadly deliver on expectations.

Delaying and diluting

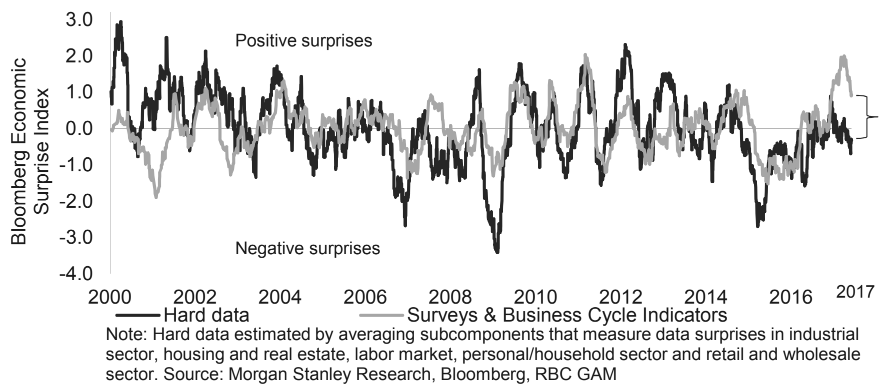
The election of Donald Trump as U.S. president last autumn was a catalyst for financial markets, with sizeable implications as well for fiscal and

Exhibit 6: Global credit impulse positive but fading



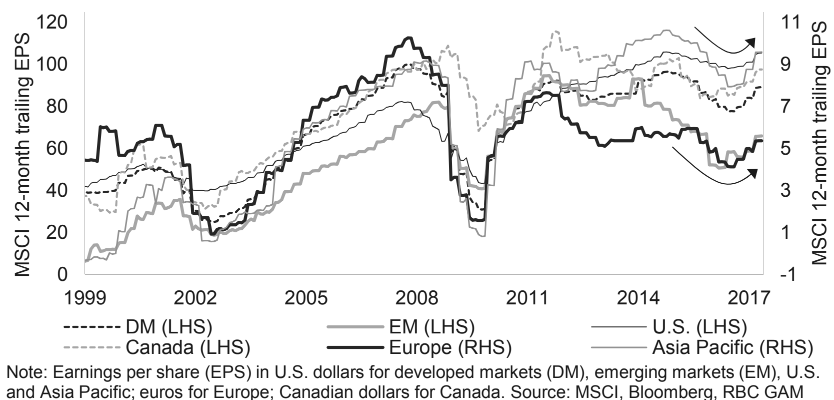
Note: Credit impulse measured as year-over-year change in year-over-year percent change in credit outstanding. Source: IIF, RBC GAM

Exhibit 7: Soft data beats hard data



Note: Hard data estimated by averaging subcomponents that measure data surprises in industrial sector, housing and real estate, labor market, personal/household sector and retail and wholesale sector. Source: Morgan Stanley Research, Bloomberg, RBC GAM

Exhibit 8: Global corporate earnings on upswing



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 GAM

foreign policy. Though now several months into the new administration, much remains only hazily sketched out. Accordingly, we now look for delayed policy action and diluted economic implications, with the net effect being slightly less negative for the long-run economy (Exhibit 10).

President Trump's various economic proposals are looking somewhat feebler for a few reasons. While Republican officeholders dominate the executive and legislative branches of government, they seem less capable of coordinating for bold action than previously imagined. This partly relates to ideological divides within the party, partly to the unpopularity of Trump himself (Exhibit 11) and partly because it is difficult to legislate cleanly without a supermajority in the Senate. Second, there is a non-trivial risk that President Trump's agenda will be tripped up by various accusations of political misdeeds that could distract from policy plans.

Still, let's not underestimate the overall consequences of the coming fiscal changes. Even in their apparently diminished state, these are still set to be significant (Exhibit 12). We look for a variety of short-term positives in the form of tax cuts, infrastructure spending, deregulation and the fruits of a positive confidence shock. Their peak positive effect should be in 2018. However, a series of longer-brewing negatives in the form of protectionism, diminished immigration and higher interest

Exhibit 9: RBC GAM GDP forecast for developed markets

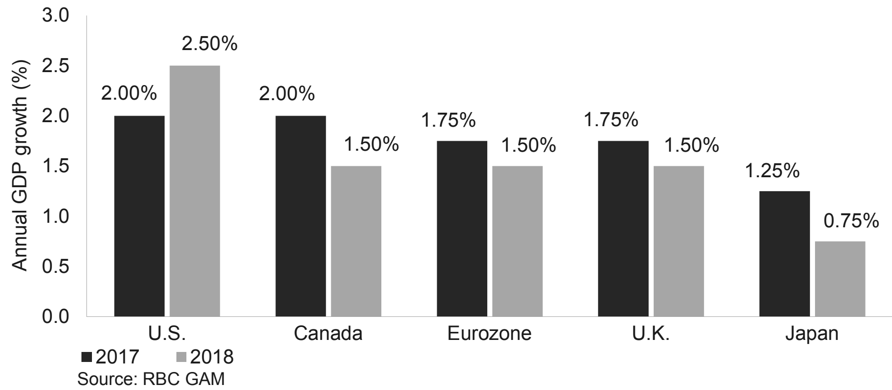
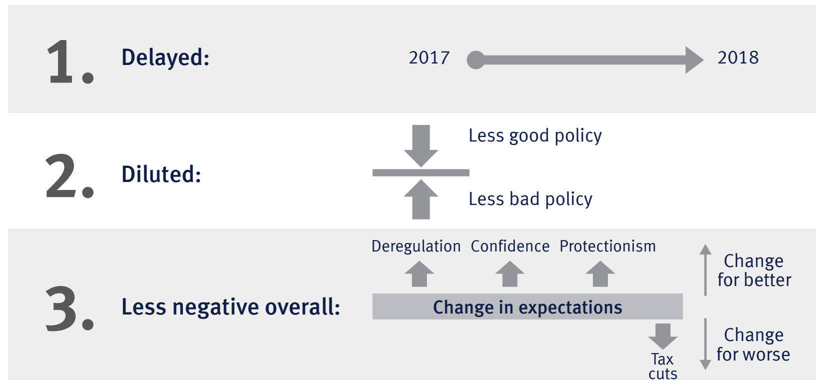
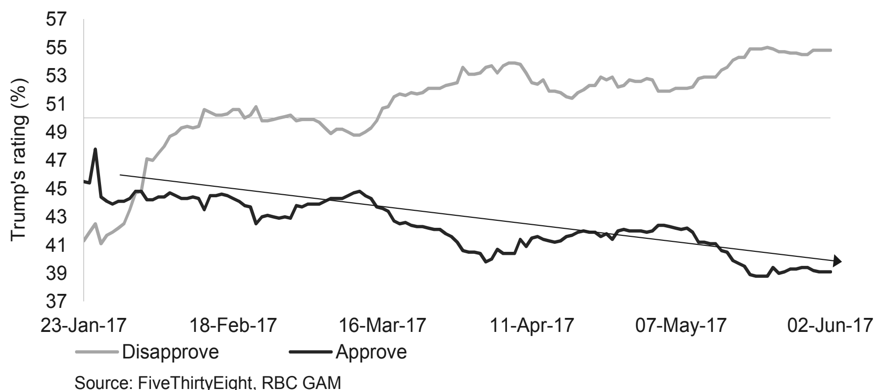


Exhibit 10: Evolution of Trump expectations



Source: RBC GAM

Exhibit 11: Trump's approval rating slides



rates could then overwhelm the positives. Over the long run, we still budget for a net negative effect, if less powerfully than previously (Exhibit 13).

Digging into some of the specific policies, the outlines of a U.S. tax-cut plan are beginning to form. Some of the more exotic aspects of earlier proposals have seemingly fallen away, such as the concept of a border-adjustment tax. But the backbone, consisting of large corporate- and moderate personal-tax cuts, remains. The precise details will remain a mystery for some time, in part because the White House continues to be vague on specifics and in part because it is ultimately Congress that sets the fiscal tune.

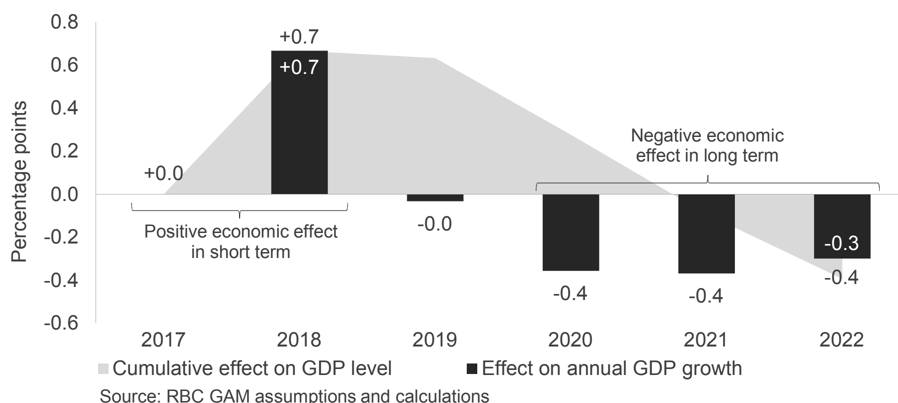
We continue to warm to the idea that deregulation could provide an important boost to U.S. growth. Our initial skepticism centered around the fact that the U.S. is not an especially difficult place to do business, landing in the 96th percentile of world rankings (Exhibit 14). However, there is some – heavily disputed – evidence of a rising regulatory burden as indicated by the expanding number of pages published each year in the Federal Register rulebook (Exhibit 15). Small businesses flag the regulatory burden as a key challenge (Exhibit 16). The initial focus on deregulating energy and financial industries should plump short-term profits in those sectors, at a minimum.

Exhibit 12: Theoretical Trump economic effects

Effect	Drivers	Net effect
Positive	• Fiscal stimulus – Tax cuts (++) – Infrastructure spending (++) – Military spending (+) • Deregulation (++) • Higher confidence (++) • Dislodge special interests (+?)	• More economic growth in the short run
Negative	• Trade barriers (––) • Tighter immigration policy (– –) • Higher rates and dollar (– –) • Populism bad for growth (–) • High policy uncertainty (–?)	• Less economic growth in the long run • Net effect of short term and long considerations is negative

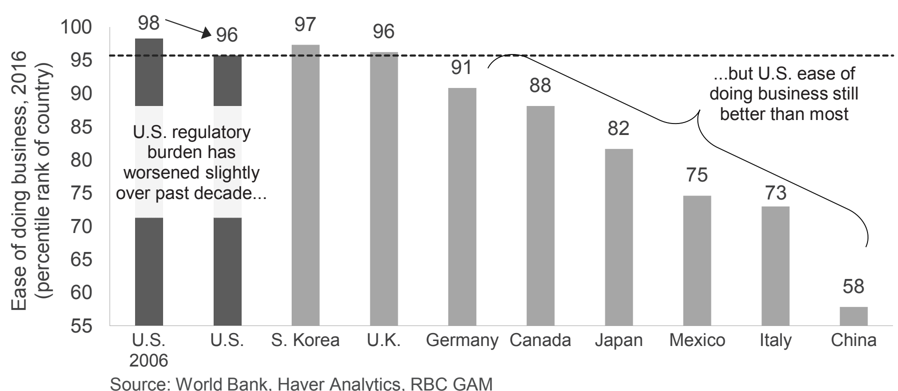
Source: RBC GAM

Exhibit 13: Effect of Trump policies on U.S. GDP



Source: RBC GAM assumptions and calculations

Exhibit 14: Conventional measure suggests little scope for U.S. deregulation tailwind

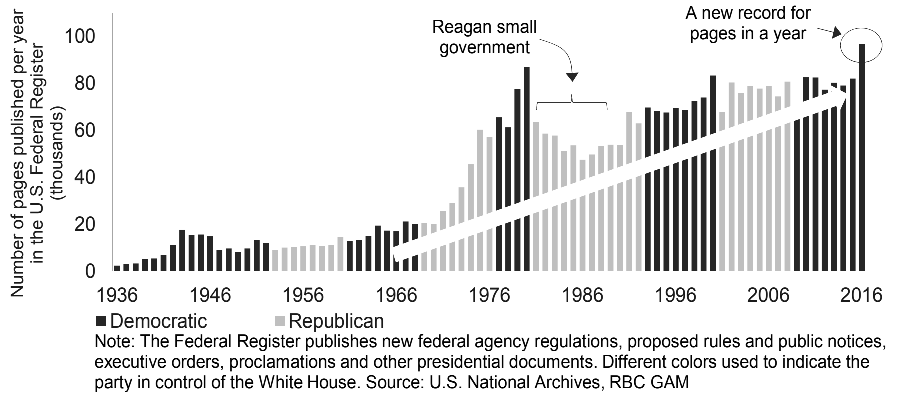


Source: World Bank, Haver Analytics, RBC GAM

On the negative side of the ledger, the hanging sword of protectionism is arguably the biggest risk. Protectionism tends to be economically damaging for all involved parties (Exhibit 17). It should be conceded that the U.S. is actually right in asserting that it is currently getting the raw end of the trade deal. We calculate that U.S. companies tend to pay higher tariffs when accessing foreign markets than foreign companies do coming into the U.S. (Exhibit 18). The only way this could end well is if the U.S. takes a constructive approach by pressuring other countries to pull down their barriers rather than imposing its own new ones. This may yet happen. However, the prospect of higher tariffs is not just real but already happening for Canadian softwood lumber, with several other sectors seemingly on the table.

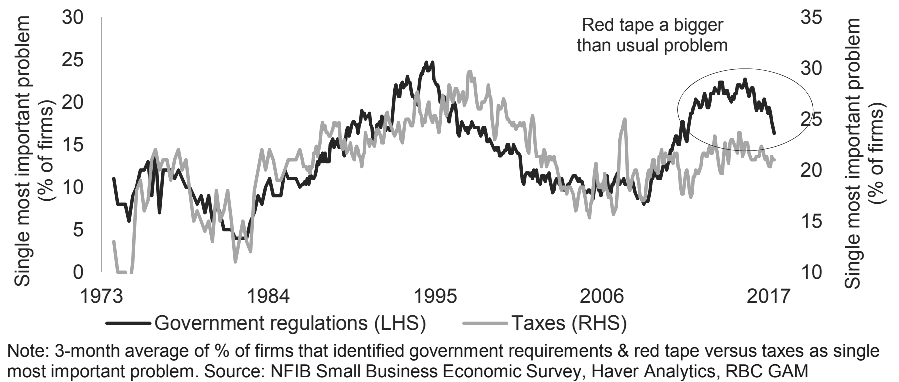
Given the new administration's mercantilist attitude toward trade, the question of who to target should be simple enough: hit those countries "responsible" for the U.S. trade deficit. There is no debate on this matter: China represents fully 60% of the total, with Germany, Mexico and Japan also significant contributors (Exhibit 19). Strangely, however, Canada has taken the brunt of the initial impact despite the U.S. having a trade surplus with Canada. It would appear that geopolitical interests outweigh economic ones, with the effect that China is getting a free pass for the time being as Trump tries to get increased Chinese cooperation on North Korea.

Exhibit 15: A rising U.S. regulatory burden?



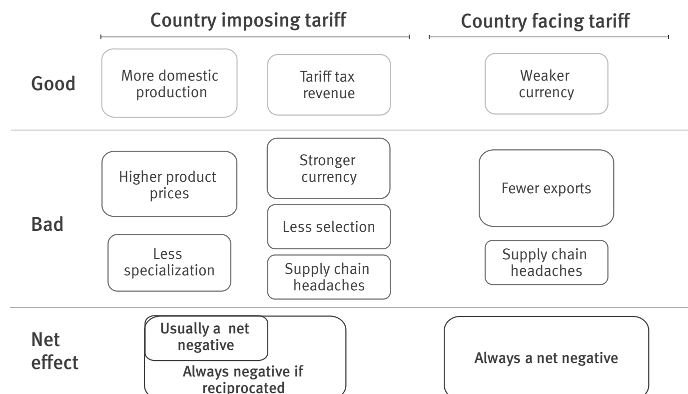
Note: The Federal Register publishes new federal agency regulations, proposed rules and public notices, executive orders, proclamations and other presidential documents. Different colors used to indicate the party in control of the White House. Source: U.S. National Archives, RBC GAM

Exhibit 16: Government regulations squeeze U.S. small businesses



Note: 3-month average of % of firms that identified government requirements & red tape versus taxes as single most important problem. Source: NFIB Small Business Economic Survey, Haver Analytics, RBC GAM

Exhibit 17: Theoretical tariff considerations



Source: RBC GAM

Although initial proposals to change NAFTA sound limited on the surface, they may ultimately be more consequential than first imagined. The proposed changes would substantially defang the agreement by reducing the ability of companies or countries to seek remedies for the actions of other parties that are in violation of NAFTA, and might also permit temporary tariffs under certain conditions within the NAFTA framework. President Trump has even mused about tearing up the agreement altogether, though that notion has recently been shelved.

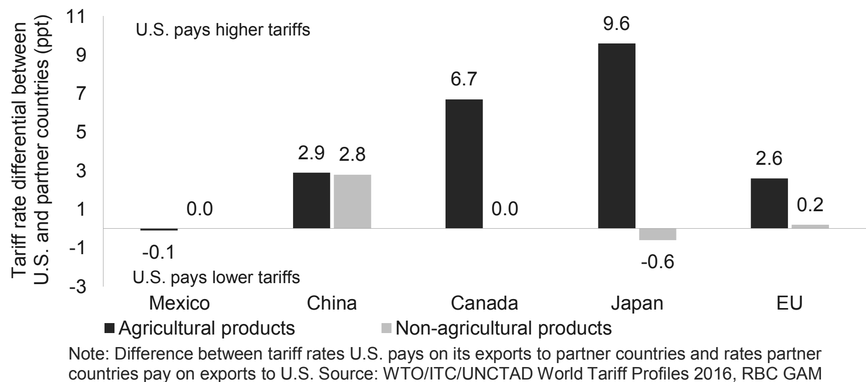
Post-crisis drags fade

Among the various explanations for the recent bout of faster economic growth, the most optimistic one is that the gravitational pull of the financial crisis could be starting to fade. This might, the theory goes, unleash a wave of permanently faster growth.

This is conceivable for a few reasons. A simple justification is that sufficient time has passed such that the memory of the trauma and its concomitant drag on risk-taking may be starting to fade. Past financial crises have tended to fully unwind over the span of a decade – not dissimilar to the amount of time that has now passed in this cycle.

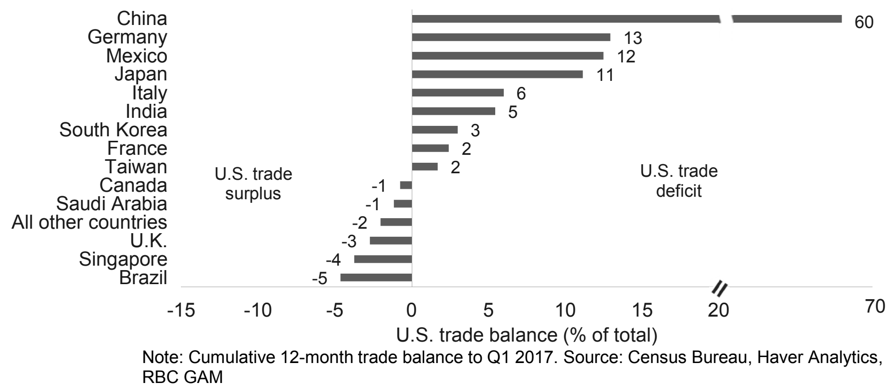
Another idea – expounded recently by the IMF's former chief economist – is that whereas a negative confidence shock may have pushed economic expectations sharply downward and thus

Exhibit 18: U.S. gets bad tariff deal versus partners



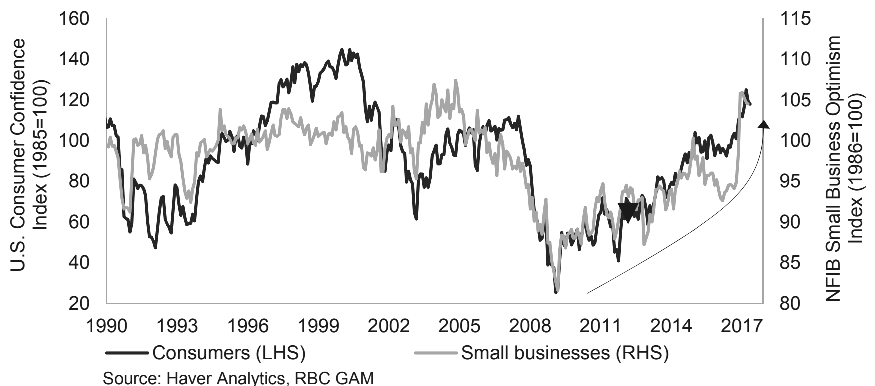
Note: Difference between tariff rates U.S. pays on its exports to partner countries and rates partner countries pay on exports to U.S. Source: WTO/ITC/UNCTAD World Tariff Profiles 2016, RBC GAM

Exhibit 19: U.S. trade deficit with China tops the list



Note: Cumulative 12-month trade balance to Q1 2017. Source: Census Bureau, Haver Analytics, RBC GAM

Exhibit 20: U.S. consumers and businesses pumped



Source: Haver Analytics, RBC GAM

repressed subsequent economic activity, the recent positive confidence shock (Exhibit 20) could have the effect of reversing that process (Exhibit 21).

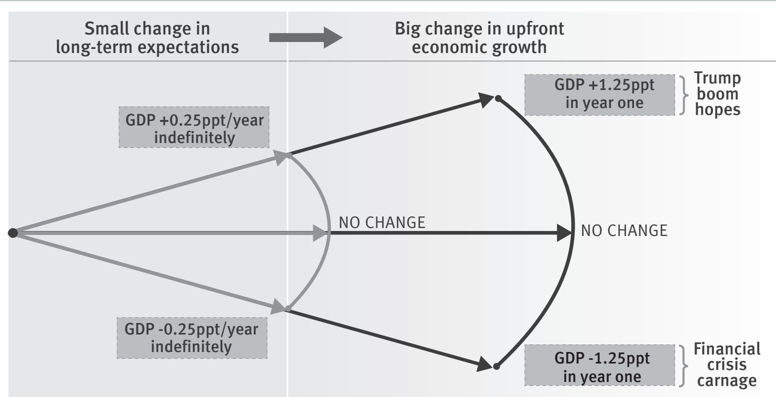
Further ammunition comes from the type of fiscal stimulus expected in the U.S. Both demand-side and supply-side fiscal stimulus can boost economic growth, but only the supply-side variety does so in a lasting way and without threatening to overheat the economy (Exhibit 22). The verdict on this front is mixed: the widely expected U.S. tax cuts are primarily a form of demand-side stimulus, but deregulation and infrastructure spending have supply-side elements that could more permanently boost growth without introducing undesirable inflation.

In the end, we budget for a bit more economic growth over the next few years than was managed over the past several. However, let's not forget that there are still plenty of reasons why the sustainable growth rate is notably lower than it was a decade or two ago, and they are rooted in deteriorating demographics and a changing economic structure (Exhibit 23).

Diagnosing downside risks

As is always the case, downside risks abound. The top three are arguably the threat of protectionism, an aging business cycle and precarious international relations (Exhibit 24).

Exhibit 21: End of secular stagnation? Hope springs eternal



Source: Peterson Institute (PB 17-6), RBC GAM

Exhibit 22: Not all fiscal stimulus is created equal – Trump stimulus risk

Effect	Demand-side stimulus	Supply-side stimulus
Examples	• Government spending • Tax cuts • Infrastructure (due to extra spending)	• Structural reforms • Deregulation • Investment-inducing tax cuts • Infrastructure (due to bigger capital stock)
Idea	• Demand-side stimulus tries to spur more demand. • This increases the pace of economic growth and results in less economic slack, more inflation and tighter monetary policy.	• Supply-side stimulus increases the productive capacity of the economy. • This raises productivity growth, but doesn't erode economic slack, increase inflation or require tighter MP.
In recession	Best	OK
Late cycle	Dangerous	Best

Source: RBC GAM

Exhibit 23: Keep structural headwinds to economic growth in mind

Human factors	Economic structure	Post-crisis
• Slower pop. growth • Rising retired % • Decelerating gains: – Education – Health – Urbanization • Falling labour mobility	• Fading globalization • Declining creative destruction – Lower firm turnover – Higher firm concentration • Goods → services • Maturing EM economies **Technology** • Running out of new, transformative innovations?	• Populism/protectionism • Secular stagnation – Diminished expectations – Less business investment – Skill decay • Debt excesses – Servicing – Deleveraging

Source: RBC GAM

Protectionism is a central risk given the rise of populism and the isolationist foundation that girds the movement. Brexit will unavoidably ratchet up the level of protectionism, and U.S. trade policy seems likely to do the same. Various European populist risks also swirl. Few new trade deals are being struck and subtle non-tariff barriers are also on the rise. For context, the IMF calculates that a 10% global tariff would subtract a large 2% from worldwide economic output over several years. No one is proposing anything quite that severe, but the point is that the stakes are high.

The aging business cycle also continues to merit careful tracking (Exhibit 25). Nothing whatsoever points to an imminent recession, but the risk is not trivial over the next few years for a few reasons.

First, it is rare for expansions to last the eight years that this one has already managed, with research suggesting that downturns are about twice as likely as normal once the cycle has persisted this long.

Second, the credit cycle is also maturing. Evidence includes the fact that credit spreads are now quite narrow, U.S. bank lending is slowing and motor-vehicle default rates are rising.

Third, economies are visibly becoming tighter. There is less slack hanging loosely off economies than was the case a few years ago. In one sense this is a fantastic thing because it represents progress in absorbing long-unemployed workers and healing other ills. However, it is also true that economies become quite slippery once they have reached their full potential, not infrequently slipping back into recession shortly thereafter. At this point, the U.S. economy looks as though it may be entering the "late cycle" phase, though by no means does it suggest "end cycle."

All told, we figure the U.S. has perhaps a 25% chance of tumbling into a recession over the next year. Pessimists will note that this is around twice the normal risk for any one year. Optimists will note that the risk was arguably higher in the early going of 2016 than it is today, and also that these odds mathematically imply that a continuation of the economic expansion is still three times more likely than a recession. Nevertheless, this non-trivial recession risk is a contributing factor to our gradually diminishing risk appetite as investors.

Exhibit 24: Downside risks: a constant evolution

Source: RBC GAM

Exhibit 25: Recession risk via non-traditional means

Traditional indicators	Other considerations	Variables to watch
• Most recession models blink green • Growth moving nicely • Financial conditions good • Yield curve still reasonably steep	• Other factors are concerning • Expansion is old • Economies becoming tight • Credit cycle aging • Trump uncertainty creates fat tails	• Degree of U.S. protectionism • Slope of yield curve • Financial conditions • U.S. unemployment rate • China shock

Source: RBC GAM

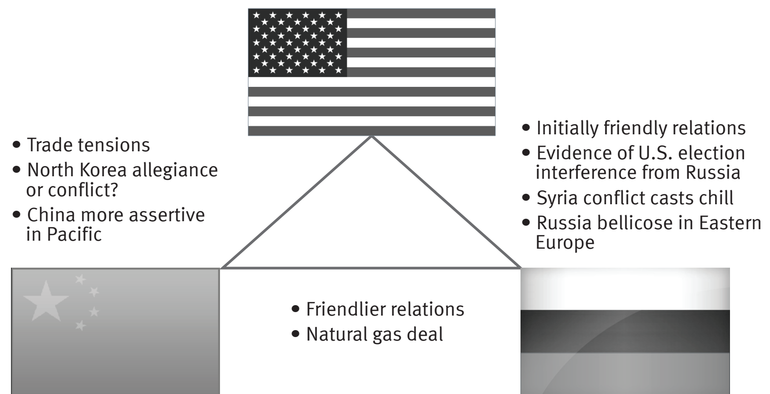
The third big downside risk revolves around geopolitics. This is partly because of acute risks emanating from the growing nuclear threat in North Korea and the ongoing military quagmire in Syria. Relations among Middle East countries are also heating up. But the rationale is equally because the world's three major military powers – the U.S., China and Russia – are all going through the fraught process of renegotiating their roles with one another at the same time (Exhibit 26). To be fair, the No. 1 lesson from past geopolitical risks is that such developments rarely have a large effect on markets, and that when they do their influence is usually reversed quite quickly. Still, given the particular uncertainty around U.S. foreign policy and the nuclear capabilities that North Korea appears to be on the cusp of achieving, these are not risks to be trifled with.

Inflation to take a breather

Inflation has made a giant leap forward over the past year, exiting a multi-year period of deflation fears in favour of a somewhat more normal inflation environment (Exhibit 27).

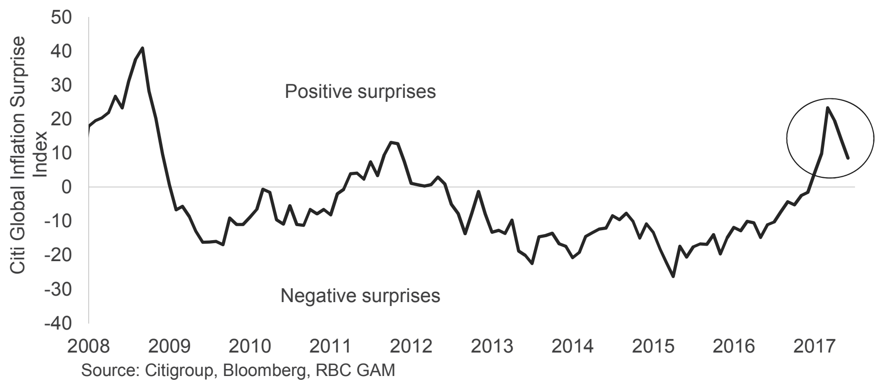
There are several reasons why this revival has occurred (Exhibit 28). The end of the global commodity shock has surely been the most visible contributor, with a partial recovery in resource prices now pushing inflation higher. Less forceful, but ultimately more persistent, is the gradual abatement of economic slack around the world and the

Exhibit 26: Geopolitical trio up for renewal after several quiet decades



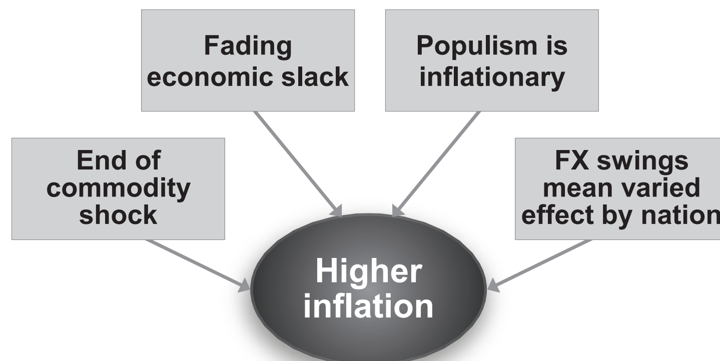
Source: RBC GAM

Exhibit 27: Global inflation surprises no longer negative



Source: Citigroup, Bloomberg, RBC GAM

Exhibit 28: Deflation fears gone: why inflation has risen



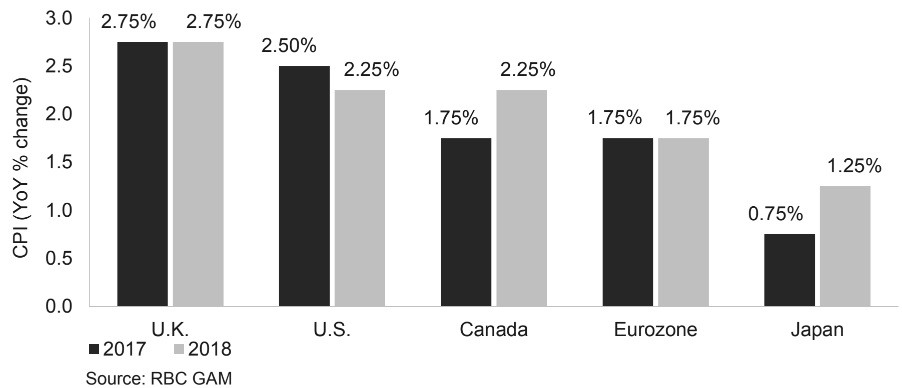
Source: RBC GAM

effect that this is having on wages and inflation. The recent burst of populism around the world is also theoretically inflationary, though often this factor takes several years to build. Lastly, most developed countries are importing a bit of extra inflation from their depreciating exchange rates against the dollar. The U.S. is naturally an exception given the dollar's general strength over the past few years, though its prices are set to be boosted by populism and fiscal stimulus more than most.

Having accelerated from rock-bottom to slightly low levels, inflation readings are now set to go mostly sideways over the next few quarters. This recognition has prompted us to slightly downgrade our 2017 inflation forecasts, leaving them a bit below the consensus (Exhibit 29).

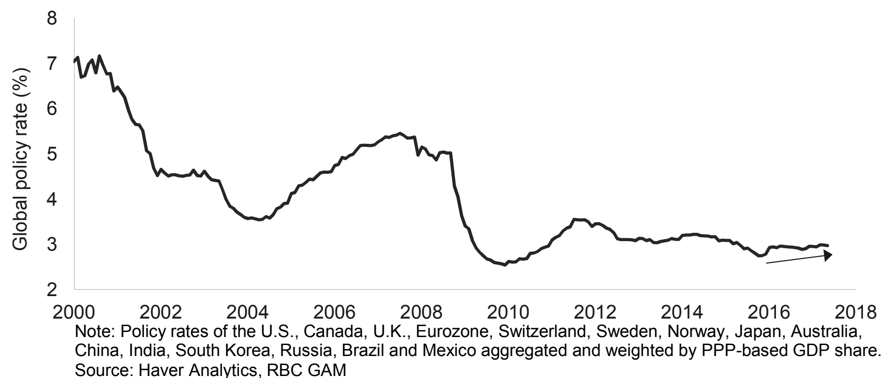
However, we persist in an above-consensus inflation outlook for 2018 and beyond as the business cycle ratchets tighter, helping among other things to bring core inflation readings up to the standard of headline inflation.

Exhibit 29: RBC GAM CPI forecast for developed markets



Source: RBC GAM

Exhibit 30: Global monetary-policy tightening has started



Note: Policy rates of the U.S., Canada, U.K., Eurozone, Switzerland, Sweden, Norway, Japan, Australia, China, India, South Korea, Russia, Brazil and Mexico aggregated and weighted by PPP-based GDP share.
Source: Haver Analytics, RBC GAM

Past peak central bank

Having long provided crucial scaffolding for economic growth, central banks have lately become a bit less stimulus-oriented (Exhibit 30). There is nothing drastic in this shift, but it is nevertheless notable after so many years with the opposite focus.

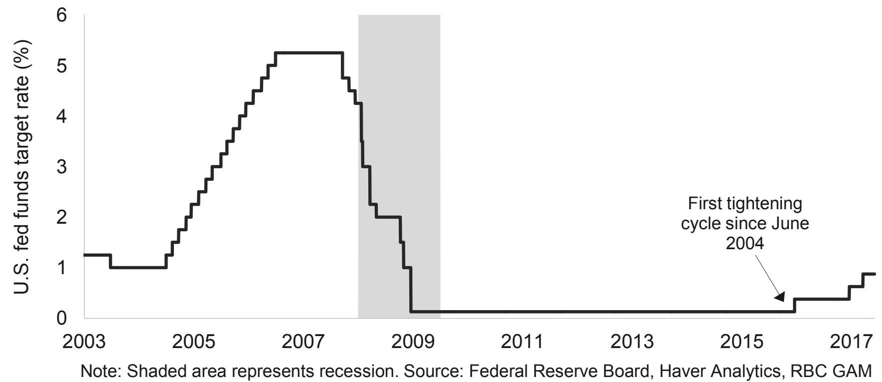
The underlying motivation for this pivot is primarily that inflation readings are no longer quite so low and that economies appear to have achieved significant progress back toward their full potential. A secondary consideration relates to worries about asset bubbles when interest rates are too low for too long. We concur with the diagnosis that slightly less monetary stimulus is becoming appropriate.

The Fed, the world's bellwether central bank, is again setting the pace with a handful of rate increases already delivered, and more on offer. The Fed also plans to begin scaling back the size of its balance sheet toward the end of the year (Exhibit 31). These actions are highly consequential on a number of fronts. They provide a central rationale for the increase in bond yields over the past year and hint of further

moderate gains. They also promise a bit less support for economic growth over the coming years. Lastly, the reality of a tightening central bank offers further confirmation that the business cycle is indeed continuing to age.

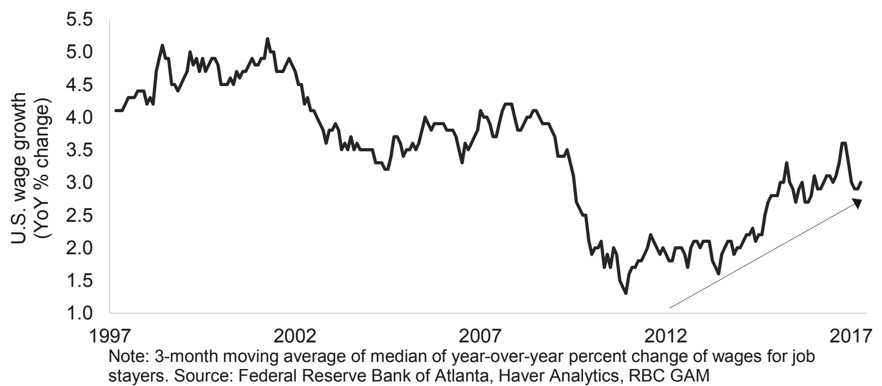
Among other central banks China has also been raising rates, though for more home-grown leveraged-related reasons. The Bank of Canada (BOC) has stopped musing about rate cuts, the Bank of England (BOE) seems content to allow its current round of quantitative easing to fade while the European Central Bank (the ECB) has already tapered its pace of bond buying slightly, though it is in no hurry to unwind its balance sheet.

Exhibit 31: U.S. rate normalization on course



Note: Shaded area represents recession. Source: Federal Reserve Board, Haver Analytics, RBC GAM

Exhibit 32: U.S. wage growth ascending steadily



Note: 3-month moving average of median of year-over-year percent change of wages for job stayers. Source: Federal Reserve Bank of Atlanta, Haver Analytics, RBC GAM

U.S. economy tightening up

The U.S. economy shows considerable economic health, though with hints that growth has peaked. The U.S. ISM Manufacturing Index is now moderately lower than its February high, but still consistent with solid growth. Economic surprises are no longer as consistently positive as before. While first-quarter GDP was weak, this was partly a function of seasonal distortions and second-quarter tracking points to a welcome offset. Hiring is still good, if decelerating moderately.

As discussed earlier, U.S. fiscal stimulus will have to wait until 2018 to provide a material boost to growth, while monetary stimulus is set to be steadily removed both this year and next. Due to the delayed fiscal stimulus we have slightly downgraded our 2017 U.S. growth forecast to 2.00% and upgraded the 2018 outlook to 2.50%.

Providing some sense for the progress being made in the U.S. economy, the unemployment rate is now an impressively low 4.3% and wage growth is grinding higher (Exhibit 32). Whereas the consumer has long been a source of strength, business investment has lately revived (Exhibit 33). Part of this is due to recovering U.S. oil producers, but some may also reflect a broader sense of optimism. The housing market continues to roll along, with room for further moderate gains.

On the other hand, the U.S. credit situation is a source of middling concern. The banks themselves appear quite sound, but sub-prime auto loans in particular appear to be struggling. Banks are tightening their overall lending standards and

have materially reduced the rate of loan growth (Exhibit 34). These credit trends are further hints of an advancing business cycle.

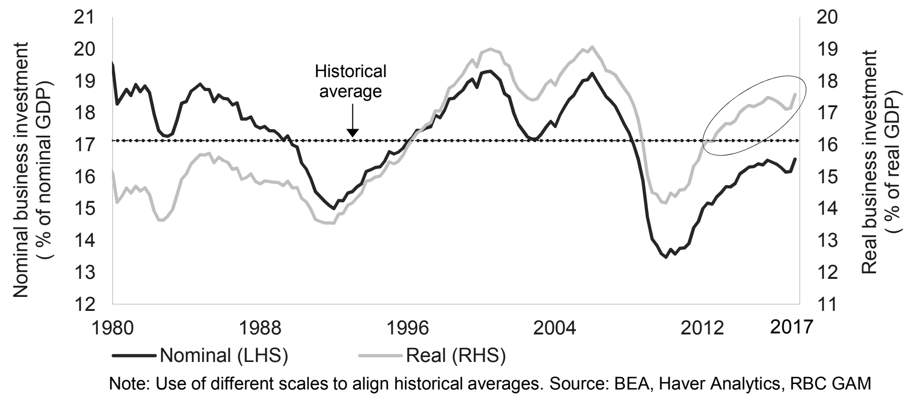
The U.S. dollar is already six years into an appreciation cycle, with perhaps another year or two left to run of modest gains if history is any guide. The strongest upside case for the greenback revolves around the Trump administration's possible imposition of tariffs on U.S. trading partners. This classically strengthens the initiating country's exchange rate as a means of restoring competitive equilibrium.

Europe's good-news story

The Eurozone economy has long tracked the U.S. along a similar trajectory but with a lag of several years. The analogy is not perfect in a broader context given that European banks and the region's sovereign debt are in worse shape, but there are many parallels. This pattern is promising given the reasonable success of the U.S. in recent years.

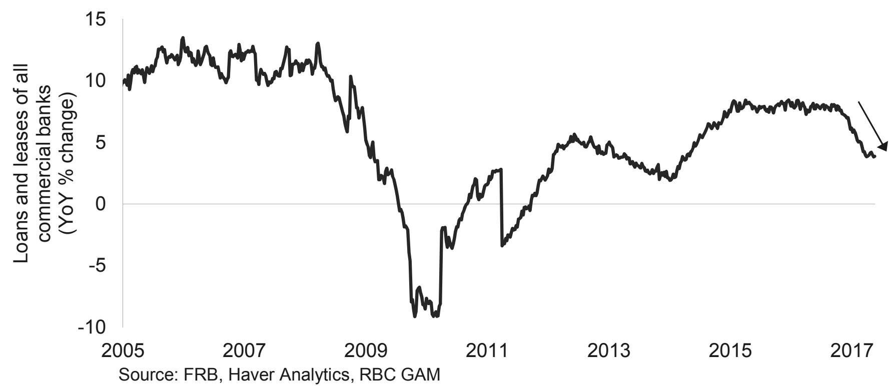
Given that Europe stands to benefit little from anticipated U.S. fiscal-policy changes, it would seem that there is more to the global economic uptick than the so-called "Trump bump." Both core and peripheral Europe are accelerating, meaning this is not a rehashed version of the "Germany versus the rest" narrative (Exhibit 35). We continue to forecast Eurozone growth of 1.75% in 2017 followed by a solid 1.50% print in 2018.

Exhibit 33: Real U.S. business investment above normal and rising



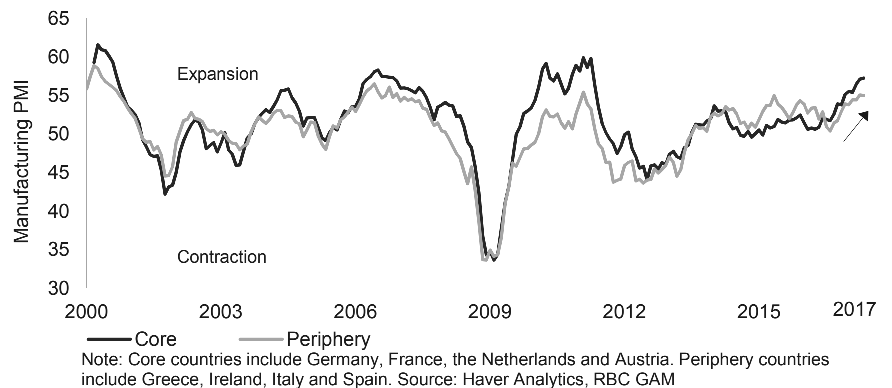
Note: Use of different scales to align historical averages. Source: BEA, Haver Analytics, RBC GAM

Exhibit 34: U.S. credit creation has slowed notably



Source: FRB, Haver Analytics, RBC GAM

Exhibit 35: Manufacturing strengthens in both core and peripheral Europe



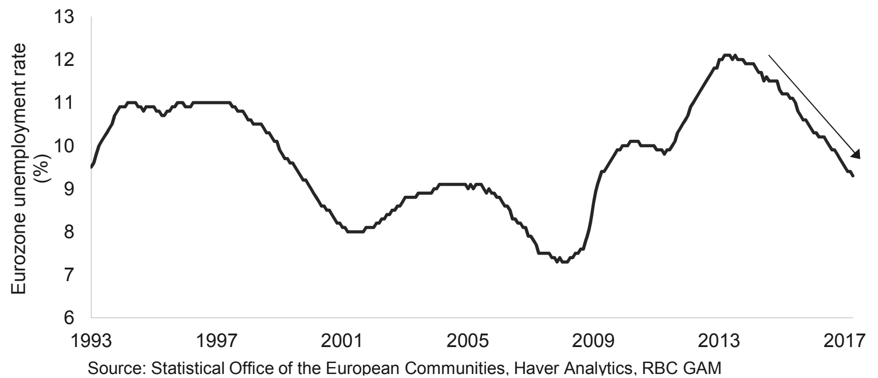
Note: Core countries include Germany, France, the Netherlands and Austria. Periphery countries include Greece, Ireland, Italy and Spain. Source: Haver Analytics, RBC GAM

Providing further support, the ECB is maintaining a highly stimulative stance and the region has a lower risk of bumping into economic constraints given the material slack left to run through (Exhibit 36). We continue to forecast a helpfully softer euro, targeting 1.02 versus the U.S. dollar in a year's time.

Where Europe has often stumbled is on the political file. Populist forces have been a serious concern and the risk of a Eurozone breakup has occasionally been frighteningly high (Exhibit 37). The good news is that these political risks have declined significantly, at least in the short run. A wave of potentially populist elections have recently managed to avoid trouble in Austria, the Netherlands and France. The German election this fall remains unconcerning. In fact, it would seem that the combination of Brexit and the new U.S. president's isolationist tendencies have prompted Europe to fuse together more tightly.

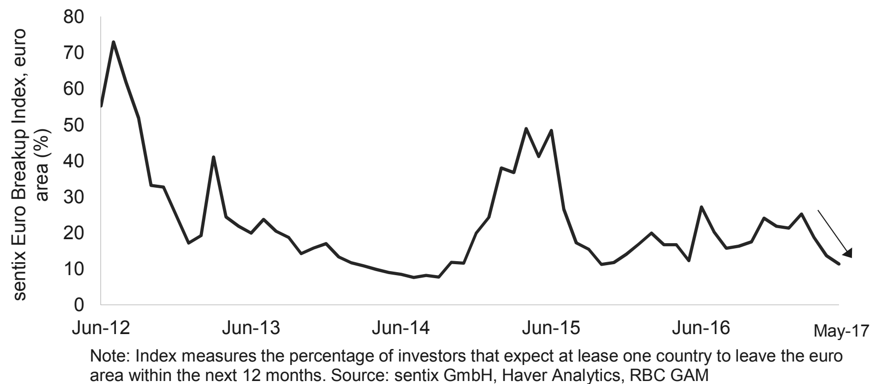
To be fair, we still fret over longer-brewing concerns about the durability of the Eurozone. Italy's next election, set for late 2017 or early 2018, will be contentious and conceivably dangerous. Negotiations over the latest Greek bailout installment have also been contentious. More generally, the continent's banks and sovereign-debt loads still possess the potential for trouble, and global populism has not run its full course.

Exhibit 36: Eurozone unemployment can continue falling



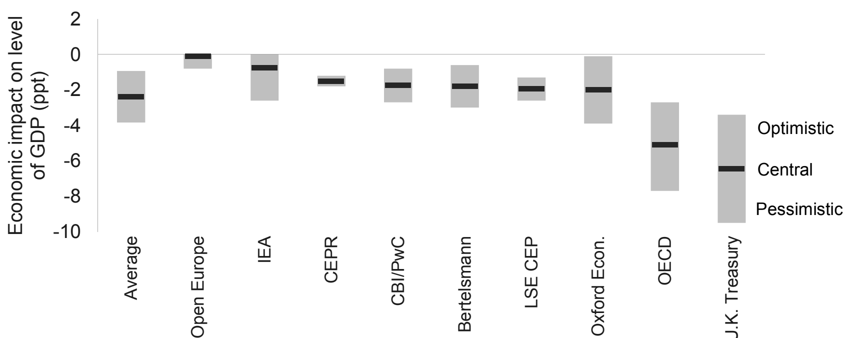
Source: Statistical Office of the European Communities, Haver Analytics, RBC GAM

Exhibit 37: Expectations of a Eurozone breakup have fallen



Note: Index measures the percentage of investors that expect at lease one country to leave the euro area within the next 12 months. Source: sentix GmbH, Haver Analytics, RBC GAM

Exhibit 38: Most models predict a moderate Brexit hit to GDP



Note: Projections cover varying timeframes. Source: Barclays, The Economist, OECD, U.K. Treasury, RBC GAM

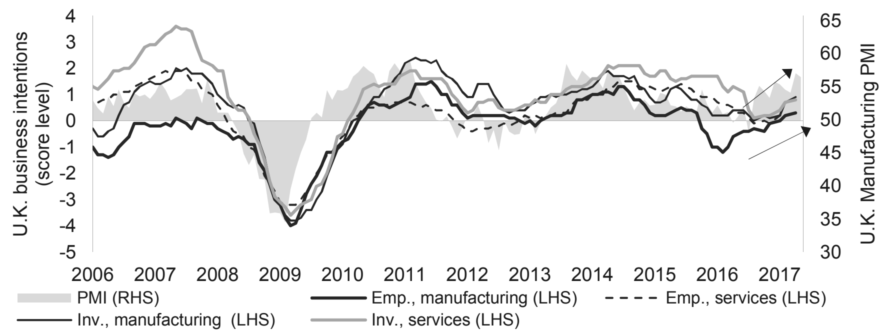
Sterling to the rescue

The British economy has also happily partaken in the global economic acceleration. Despite the expected onset of economic problems linked to the U.K.'s plan to secede from the EU (Exhibit 38), few problems have shown up in the data so far. Businesses of various stripes are still feeling surprisingly good (Exhibit 39), and money-supply growth has picked up nicely.

A key reason for this defiant economic strength can be found in the soft currency, which (Exhibit 40) has done its job as a shock absorber to augment British competitiveness at precisely the time this help was needed most. We forecast a further significant depreciation in sterling over the next year to 1.15 versus the dollar. As such, the British economy can likely continue to expand at a 1.75% rate in 2017 followed by a 1.50% clip next year. These are slightly above-consensus forecasts.

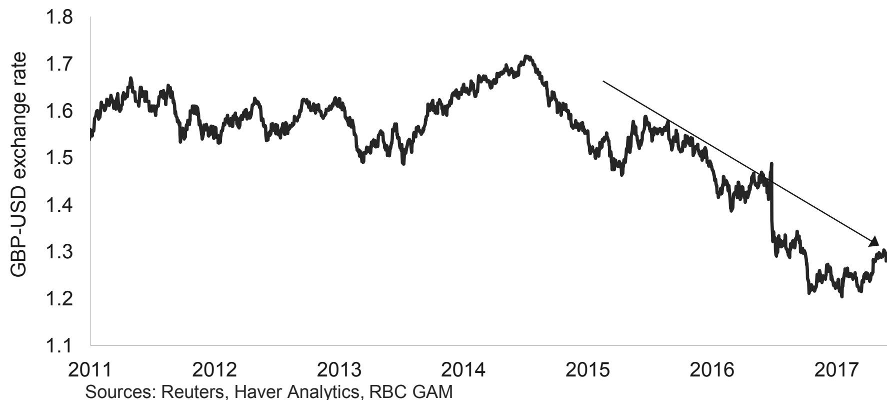
Even so, it remains a mystery why the extreme level of public-policy uncertainty in the U.K. – due to Brexit and the country's recent electoral surprise – is not having a more palpably negative effect on the economy. This seeming lack of concern extends beyond the U.K., with markets surprisingly blasé about uncertainty almost everywhere in the world. Beyond adding to the political fog, the recent British election also hints of a slightly softer Brexit and a more expansionist fiscal policy.

Exhibit 39: U.K. corporations still point to growth



Note: U.K. business intentions in hiring and investment of manufacturing and services sectors. Scores range from -5 (rapid contraction) to +5 (rapid growth). Source: BoE, IHS Markit, Haver Analytics, RBC GAM

Exhibit 40: Post-Brexit U.K. propped up by weak pound



Sources: Reuters, Haver Analytics, RBC GAM

A further medium-run challenge for the British economy is the country's low savings rate. Consumption growth has substantially outpaced personal income, sending the household-savings rate to unusual depths. Moreover, the U.K.'s gaping current-account deficit remains largely unresolved.

Although some BOE voters would prefer a rate increase at this juncture, most continue to judge that the current level of stimulus is appropriate given the future economic challenges associated with Brexit.

Japan stilling missing structural reforms

The Japanese economy has managed to stitch together an unusually long stretch of half-decent economic growth (Exhibit 41). While some domestic considerations are at play, the main narrative is again one of a stronger global economy, as

reflected in faster exports, higher profits, stronger credit growth and an improved purchasing managers' index. Indeed, global trade has picked up in recent months, which is of particular relevance to trade-oriented Japan. We attribute the pick-up in trade to cyclical effects as opposed to the notion that globalization is suddenly reviving in a more sustained way.

The knock on Japan remains that it is delivering too few structural reforms. That aspect of Prime Minister Abe's bold stimulus package has had a few tentative successes – higher female labour-force participation rate, for instance – but has failed to truly shake up Japan's insular business culture. The long delays and eventual abandonment of the Trans-Pacific Partnership trade deal with the U.S. is an unfortunate blow for the country. As such, we believe Japan's structural economic speed limit is still quite low. Japan is among the more at-risk economies in the developed world should U.S. protectionism turn serious.

We expect Japan to manage economic growth of 1.25% in 2017 and just 0.75% in 2018 given our expectation that the yen won't weaken much over the forecast horizon.

Still, Japan's inconsistent expansion of the last several years has been sufficient to seriously tighten the island nation's economy (Exhibit 42). As such, we continue to budget for a bit more inflation than the market expects, while recognizing that

Exhibit 41: Japan's economy no longer sputtering

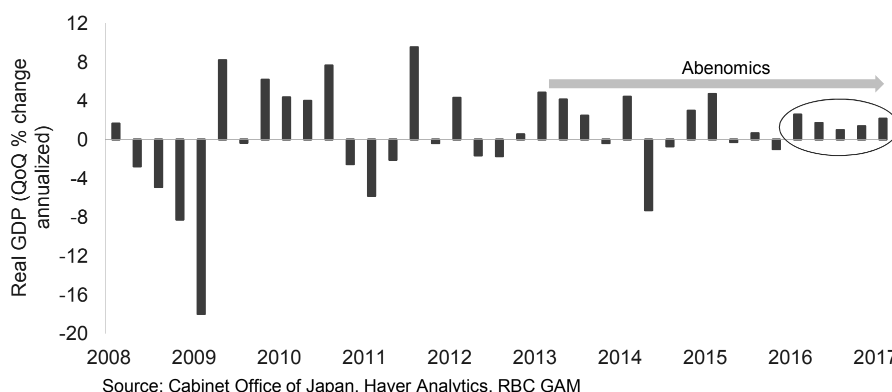
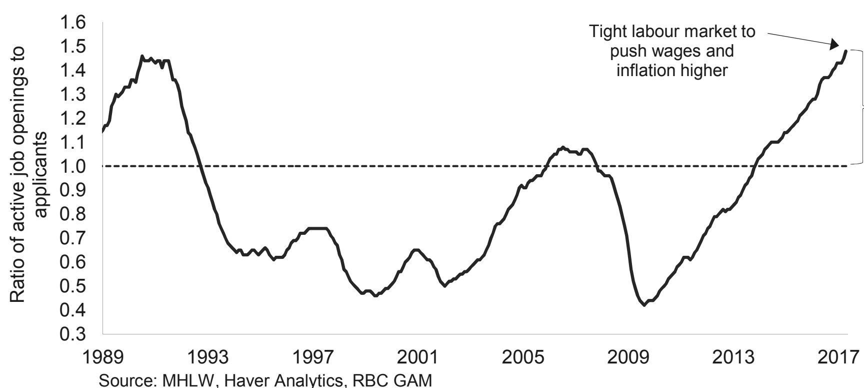


Exhibit 42: Japan's labour market continues to tighten



Japan's aging population constrains its ability to achieve fully normal inflation readings.

Japanese monetary policy appears locked into maximum stimulus mode, and little should change after Japan picks its next BOJ governor in 2018.

Emerging markets march to their own drummer

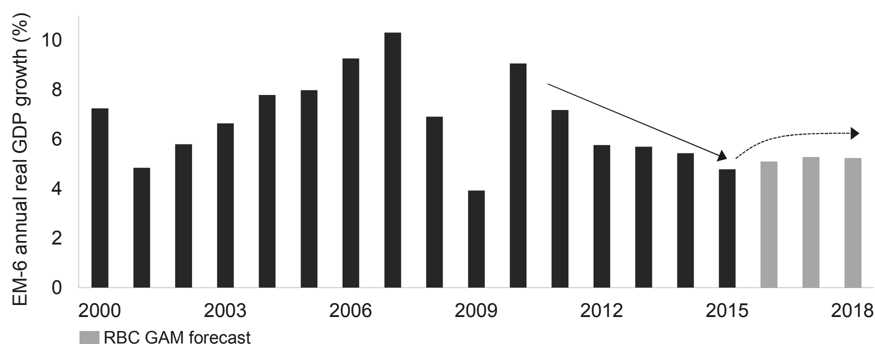
Emerging-market economies collectively suffered through a multi-year period of decelerating economic growth, before righting themselves in recent years. They are now on track to grow at a solid 5.25% in both 2017 and 2018. Admittedly, this rate pales in comparison with a decade ago, when globalization was still in full bloom and credit excesses were ascendant. But is still more than double the developed-world clip and thus an admirable pace in a growth-starved world (Exhibit 43). Emerging-market leading indicators also enjoyed a notable boost over

the past year that may now be peaking. This latest inflection does not signal an imminent slowdown but instead simply that the recent acceleration is now stabilizing. We have upgraded our emerging-market growth forecast slightly for both 2017 and 2018, though these remain a bit below the consensus.

Beneath the surface, individual emerging-market economies are marching to their own drummer. In the short run, China appears to be moving a bit faster than previously envisioned (Exhibit 44) and so we have upgraded the country's 2017 outlook to 6.5% growth. Mexico has also received a slight upgrade as it benefits from a weaker currency without yet suffering the ill effects of U.S. protectionism. India, Brazil and Russia have had their near-term forecasts downgraded slightly (Exhibit 45).

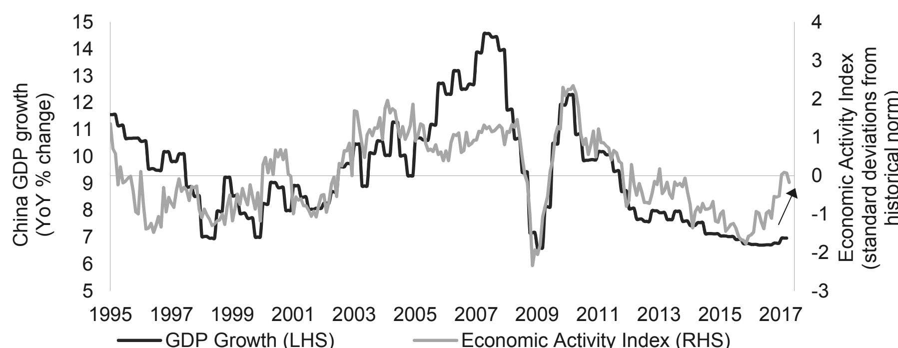
Looking slightly further into the future, fundamental growth drivers become more important. To properly evaluate these prospects, we consider six filters to differentiate among emerging-market nations. These are: whether countries are delivering important structural reforms; whether they are gaining or losing competitiveness; whether they appear vulnerable to U.S. protectionism; whether they must grapple with prior credit excesses; whether they benefit from the recent rebound in commodity prices; and whether they are politically stable (Exhibit 46).

Exhibit 43: EM growth rebounds



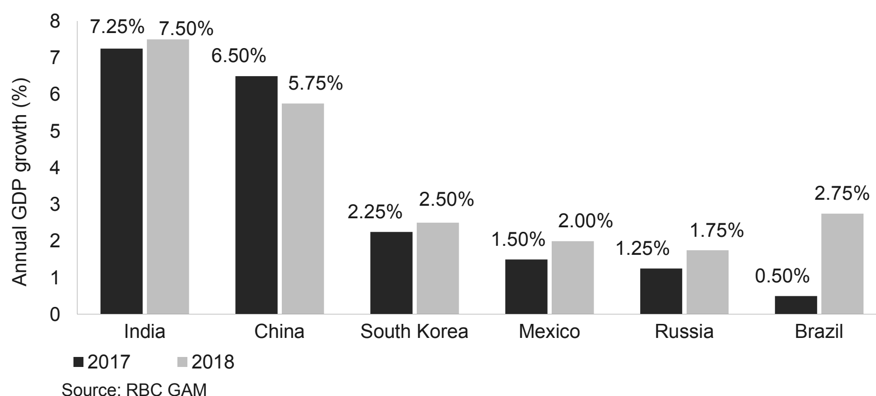
Note: EM-6 includes Brazil, China, India, Mexico, Russia and South Korea. Source: Haver Analytics, RBC GAM

Exhibit 44: China's economy has defied expectations



Note: Index constructed using sixteen proxies for real economic activity in China.
Source: Bloomberg, Haver Analytics, RBC GAM

Exhibit 45: RBC GAM GDP forecast for emerging markets



Source: RBC GAM

The collective weight of these factors puts China in a somewhat more negative medium-term position given Chinese vulnerability to U.S. protectionism, the country's lost competitiveness and the threat of significant credit excesses. Chinese policymakers are scrambling to address this last concern by actively pumping the economy's brakes (Exhibit 47). We continue to look for below-consensus Chinese growth in 2018 and beyond as the country addresses these issues.

On the other hand, structural reforms in India and commodity rebounds in Brazil and Russia are helping those countries in the multi-year outlook.

Canada races into the unknown

The Canadian economy finds itself racing forward at its fastest clip in several years, having shrugged off the worst of the oil shock and set to benefit from a further moderate appreciation in the price of crude oil over the remainder of 2017 (Exhibit 48). Lingering fiscal stimulus is also providing a helping hand in 2017.

In defiance of the international mood, Canada has bucked the anti-trade trend by signing a European trade deal and starting the process of tearing down trade barriers among provinces.

Canada's regional economic convergence is running ahead of schedule, with Alberta's economy now growing at a faster clip than

Exhibit 46: Varied EM economic drivers at national level

Outook for:	China	India	Korea	Brazil	Mexico	Russia
Structural reforms	+ +	+ +	0	+	+	–
Competitiveness	– –	0	0	0	+	0
U.S. protectionism	– –	0	–	0	– –	–
Credit	–	–	0	–	0	0
Commodities	–	–	–	+ +	0	+ +
Geopolitics	–	0	–	–	0	–
Overall	– –	0	–	0	0	0

Note: + means positive, – means negative, 0 means neutral. Source: RBC GAM

Exhibit 47: Chinese policymakers hit the brakes

Source: RBC GAM

Exhibit 48: Oil thoughts for the short and longer run

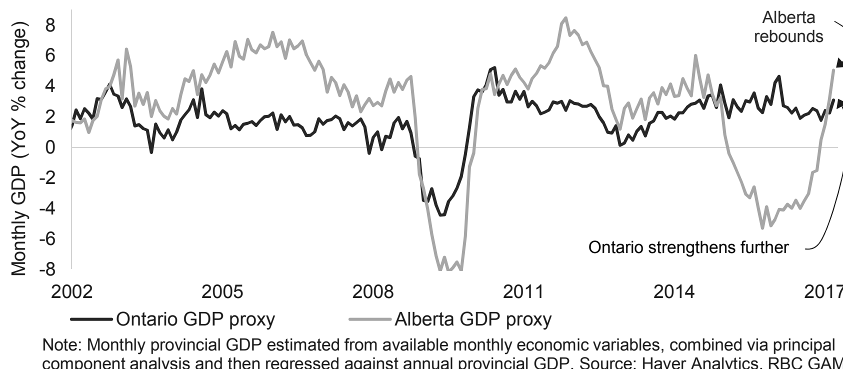
Source: RBC GAM

Ontario after lagging for several years (Exhibit 49). This doesn't mean that the country's oil-exporting provinces are no longer suffering given still-high unemployment rates, but it does mean that the pain is starting to ease. While oil prices are likely to remain too low to justify substantial new investment in the energy sector, the past year's rally in prices is making the existing production more profitable.

With the bulk of the country now clicking, Canada has gone from an unusually subdued rate of growth to a better-than-usual clip. The country's impressive first-quarter GDP growth of 3.7% provides an example of this shift. In the short run, trade flows could lend a helping hand given the expected effect of a depreciating Canadian dollar (Exhibit 50). Canada's stronger economic profile has seemingly taken the risk of rate cuts off the table in the near term even though wage growth remains anemic and inflation subdued. We price in one BOC rate hike over the next year.

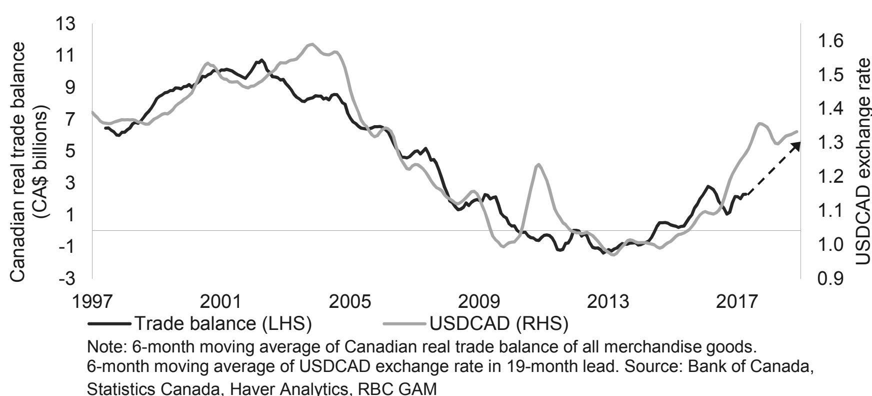
There are two unknowns that threaten this happy narrative. The first is the potentially adverse effect of U.S. public policy changes under the Trump administration. The second is the prospect of the country's housing boom coming to an end. For these reasons, we forecast solid 2.00% growth in 2017 but then assume a somewhat weaker 1.50% advance in 2018. These are both below-consensus forecasts.

Exhibit 49: Alberta has surpassed Ontario in growth



Note: Monthly provincial GDP estimated from available monthly economic variables, combined via principal component analysis and then regressed against annual provincial GDP. Source: Haver Analytics, RBC GAM

Exhibit 50: Canadian real trade balance could improve further



Note: 6-month moving average of Canadian real trade balance of all merchandise goods. 6-month moving average of USDCAD exchange rate in 19-month lead. Source: Bank of Canada, Statistics Canada, Haver Analytics, RBC GAM

Among the many considerations of a Trump presidency on the Canadian economy, we judge the negative factors to outweigh the positive (Exhibit 51). In particular, U.S. protectionism – already manifesting in the form of a new softwood-lumber tariff – could dim Canadian growth. Falling U.S. tax rates and environmental standards also present a competitive challenge to Canada, where the trends are running in the opposite direction.

Meanwhile, Canada's housing market has been an enormous driver of economic gains over the past decade, particularly in the Toronto and Vancouver markets. Regulators are now getting serious about tackling the excesses that have formed. The market has responded to these efforts, but the Vancouver experience suggests that the effect of such policies may be short-lived. It is difficult to say how all of this plays out, but we suspect additional

actions by regulators are likely and the end result should eventually be an end to white-hot home price gains. There may well be material economic consequences when this happens (Exhibit 52).

Economic backdrop warrants higher interest rates

With strengthening global economies, firming inflation in most regions and improving labour conditions, major central banks have shifted from easing monetary policy to tightening it, or by easing less. The U.S. is raising policy rates and considering how to pare its balance sheet, while the ECB reduced the pace of its monthly bond purchases in April and the Bank of Japan (BOJ) is contemplating its own steps in this direction. U.S. economic conditions are much more advanced than in Europe and Japan, with unemployment at pre-financial-crisis levels and inflation near the Fed's 2.0% target. In response, the Fed has raised rates three times since December 2015, and further tightening at a gradual pace is expected.

Validating the case for higher U.S. interest rates is the Koenig-Taylor rule, which suggests an appropriate fed funds rate could be as high as 2.8% (Exhibit 53). The model determines the ideal level of short-term interest rates based on readings of inflation, economic growth and unemployment. Although we don't expect the fed funds rate to rise as much as the Koenig-Taylor rule indicates it should, we agree

Exhibit 51: Some Canadian considerations under Trump

Good for Canada	Bad for Canada
Faster short-term U.S. growth	Slower long-term U.S. growth
Weaker Canadian dollar	Higher interest rates
Keystone XL pipeline	Protectionism / fewer exports
Better quality/more immigrants	Tax wedge opens to Canada's disadvantage
Less competition from Mexico and China	Environmental wedge opens to Canada's disadvantage
Greater motivation to pen foreign trade deals	Must meet NATO spending obligations?
Numerous positives, but negatives probably dominate	

Source: RBC GAM

Exhibit 52: Key Canadian housing factors

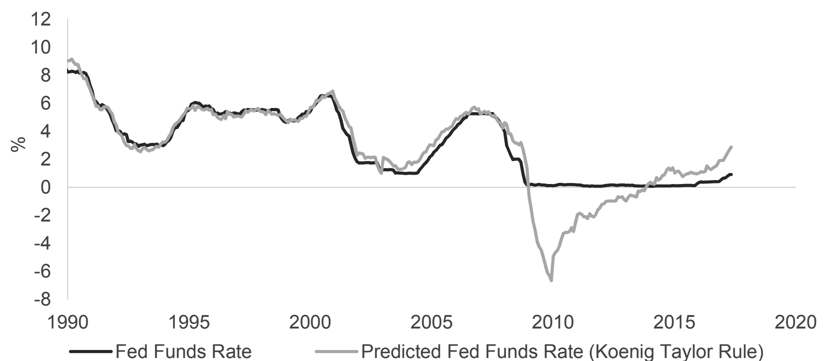
No classic sign of imminent housing bust:
- Unemployment low and falling
- Mortgage rates still very low
- Mortgage credit growth no longer signaling trouble
- Vancouver shows surprising resilience

Still, conditions becoming less friendly:
- Regulators leaning against market
- Frenzy in Toronto
- Artificially high demand
- Bad affordability=bubble

Housing outlook:
- Multiple scenarios
- Most likely is home prices flatten out
- Economy would grow 1-2ppt less over 5yrs
- Fewer housing transactions, smaller wealth effect

Source: RBC GAM

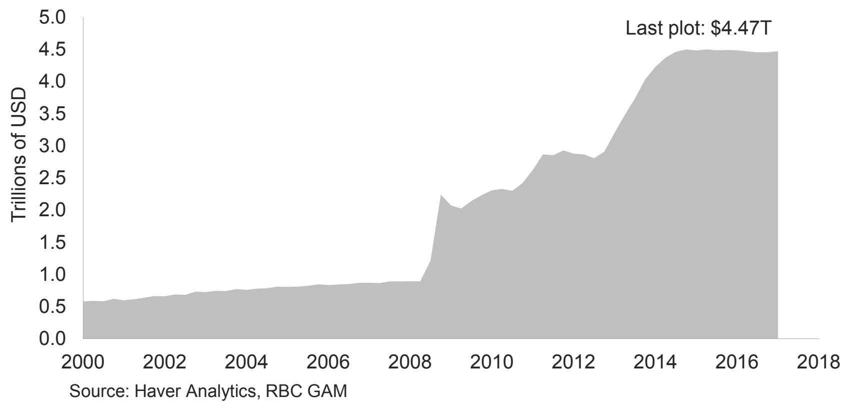
Exhibit 53: Koenig Taylor rule and fed funds rate



Source: Federal Reserve Bank of Dallas, RBC GAM

on the direction. Our expectation is for the Fed to raise rates three times over the next 12 months. The futures market is a bit more conservative, pricing in roughly two hikes over the year ahead, but with near-certainty that the next hike occurs at the Fed's June meeting. With interest rates gradually rising back to normalized levels, the Fed may soon look to dial back the size of its US$4.5 trillion balance sheet (Exhibit 54). By letting some of its bonds mature without reinvestment, the Fed will be able to reduce its assets at a measured pace that is unlikely to disrupt financial markets.

Exhibit 54: U.S. Federal Reserve
Balance sheet assets

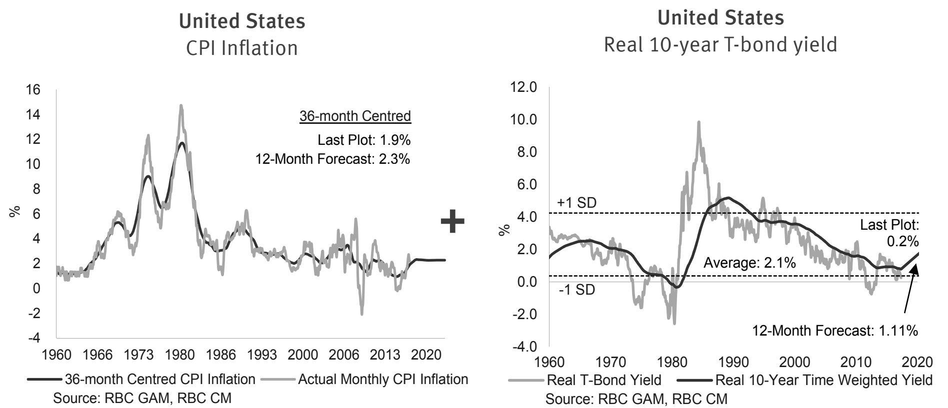


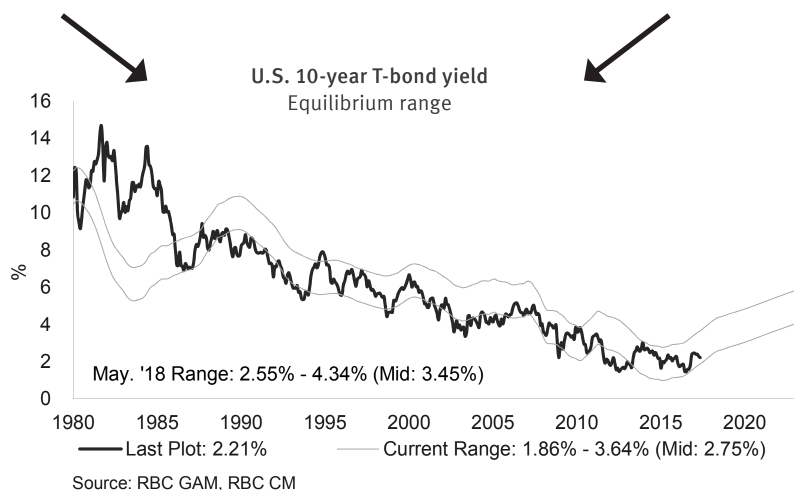
Decline in bond yields reintroduces valuation risk

Global bond yields drifted lower in the past quarter as enthusiasm about Trump's pro-growth policies receded. A lack of progress on the president's economic agenda and speculation that Trump may not serve his full four-year term has caused investors to ratchet down their growth and inflation assumptions. The resulting drop in nominal bond yields has reintroduced the valuation risk that had mostly evaporated during the initial run-up after Trump's election (see page 40).

Although the trend so far this year has been towards lower bond yields, our models continue to suggest that the long-term direction of yields is higher. The combination of a bit more inflation and an increase in real interest rates over the year ahead adds 130 basis points to our

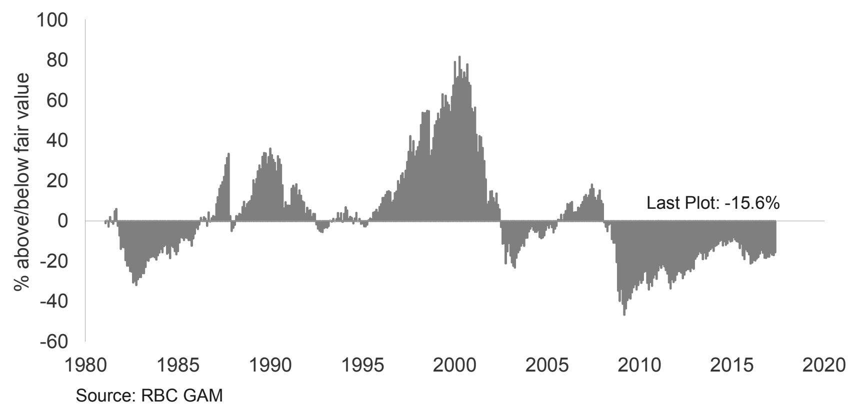
Exhibit 55: U.S. 10-year bond yield
Fair-value estimate composition





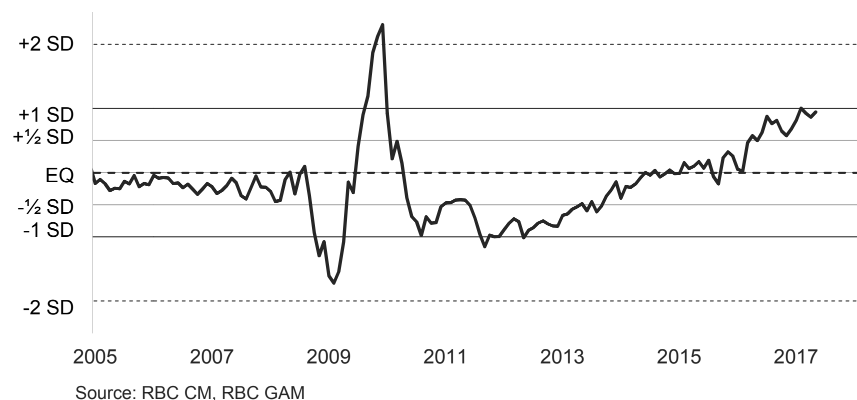
modelled equilibrium level for the yield on 10-year Treasuries. Exhibit 55 disaggregates the model to reveal its two main components: an inflation premium and the real rate of interest. On the inflation side, there is scope for a 40-basis-point increase given our forecast that a bit higher inflation will be sustained over the medium term. The bigger risk to fixed-income investors would be a sharp move higher in the real rate of interest. Our model assumes that real rates revert to their 40-year trailing average in five years' time, adding another 90 basis points to nominal yields over the year ahead. That said, a number of structural headwinds – aging populations, a limited capacity to take on debt, wealth inequality, globalization and a preference for safe assets – may limit the pace of reversion in real interest rates. In any case, we expect the direction of yields to be higher from here and our forecast for the U.S. 10-year yield is 2.50% a year out. Any deviation from our base case would likely be to the upside.

Exhibit 56: Global stock market composite
Equity market indexes relative to equilibrium



Source: RBC GAM

Exhibit 57: S&P 500 Index
Normalized (Equilibrium) Price/Earnings Ratio



Source: RBC CM, RBC GAM

Stocks march to record levels

The combination of a synchronized global expansion and an acceleration in corporate-profit growth lifted global equities to new highs in the past quarter. Most major stock markets posted gains over the three month period, with emerging markets and Europe delivering mid- to upper-single-digit returns, followed by low-single-digit-gains in Japan and the United States. Canadian equities, however, fell slightly in the quarter due to weakness in the financial and energy sectors. We recognize that stocks are not as cheap as they were when the bull market began eight years ago, but equities in Canada, Europe and emerging markets remain attractively priced (see page 41). In aggregate, our global valuation composite situates stocks at a meaningful distance beneath fair value (Exhibit 56). U.S. stocks, in particular, are beginning to show signs of concern over valuations and, given the importance of U.S. equities on global financial markets, S&P 500 valuations are worth a closer look.

Valuations may no longer be a driving force for U.S. stocks

Supported in part by low interest rates, U.S. equity valuations have recovered significantly from the depths of the financial crisis, but may no longer be a driving force for U.S. stocks going forward. The trailing 12-month P/E ratio on the S&P 500 Index is now a full

standard deviation above levels consistent with current and forecast levels of interest rates, inflation and corporate profitability (Exhibit 57). While it's not impossible for valuations to continue expanding, it's unlikely to be a significant source of gains for stocks, especially as interest rates rise from here.

Contrary to the past couple of years, a further rise in interest rates from current levels would likely weigh on stock valuations. One of the six inputs to our equilibrium P/E model is short-term interest rates, which account for a 28% weight in the calculation. Each input was regressed against over 50 years of stock-market history to determine its impact on P/E multiples, and the resulting relationship of short-term interest rates and P/Es is plotted in Exhibit 58. When Treasury bill rates rise, P/Es tend to fall and vice versa. However, note that the relationship breaks down when interest rates fall below 1.25%. Intuitively, this makes sense, as what brought interest rates below that level likely wasn't good economic news. But that means the initial rise in rates away from crisis levels has actually supported P/Es, as was predicted by the math. We've now traversed almost all of that move, however, so the normal relationship of higher short-term interest rates resulting in lower P/Es should prevail. We are running out of rope for continued multiple expansion, and further gains in stocks will likely need to come from increasing corporate profits.

Exhibit 58: S&P 500 equilibrium model
P/E factor as a function of 3-month T-Bill rate

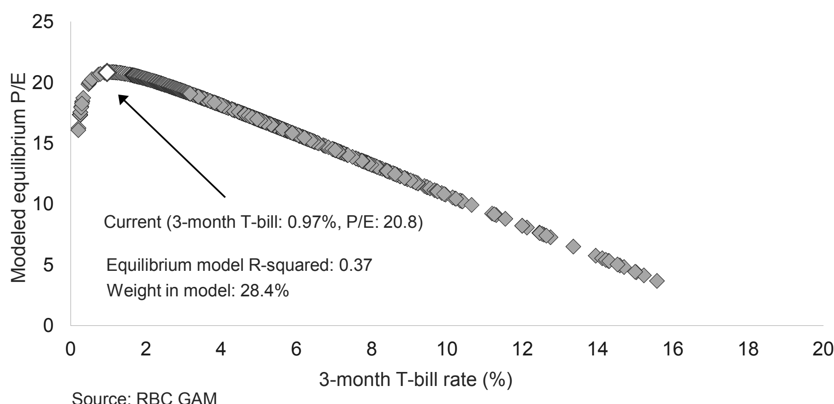
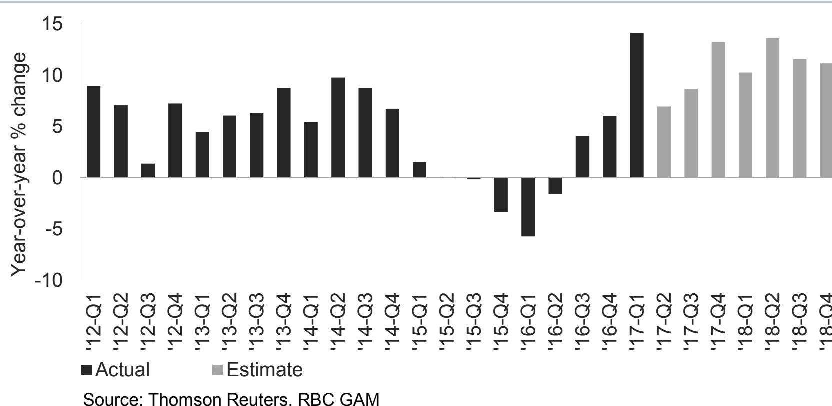


Exhibit 59: S&P 500 Index earnings per share
Quarterly earnings % change from same quarter in prior year



Earnings rise at fastest pace in post-crisis era

Fortunately for equity investors, corporate profits have recovered from their two-year swoon and are now growing at their fastest pace in the post-crisis era. In the first quarter of 2017, S&P 500 earnings rose 15% year over year on revenue growth of 7% (Exhibit 59). This acceleration in earnings is welcome after the crash in oil prices and significant strength in the U.S. dollar pulled down profits between the end of 2014 and mid-2016.

We are at a point in the cycle where profits and company sales have historically turned higher (exhibits 60 and 61). It's normal to see above-average earnings growth as earnings recover to their long-term upward trend, but the recent experience is not likely to last indefinitely. Exhibit 62 plots the S&P 500 going back to 1960 on a log scale. Notice that earnings oscillate around the long-

term trend and that they recently began to turn higher as they caught up to the long-term trend. Over the long term, however, profits tend to rise a bit more slowly – between 6% and 8% per year. In fact, a regression of GDP and profits suggests that our real GDP forecast of 2.00% for 2017 and 2.50% for 2018 would generate just 4.7% and 5.9% earnings growth, respectively (Exhibit 63), and our nominal growth estimates would yield revenue growth slightly below those levels (Exhibit 64). So while earnings and revenues can grow at a faster pace for some time, particularly if Congress approves large-scale tax cuts, they will likely slow to a pace consistent with long-term economic growth.

Further upside for stocks is conceivable

It wouldn't be unreasonable to expect further gains in equities, and if profits rise as analysts expect, the total-return potential for stocks is still quite positive. We ran several scenarios combining P/E multiples with analyst earnings estimates to gauge potential returns (Exhibit 65). Multiplying the 2017 top-down consensus of US$131.80 by a P/E of 18.9 – the multiple consistent with current and forecast levels of interest rates, inflation and corporate profitability – would put the S&P 500 at 2490.40 by year-end, generating a 4% total return from the close on May 31, 2017. Looking at 2018, given earnings of US$147.30 and the same P/E, the index would

Exhibit 60: S&P 500 recurring earnings
All earnings peaks associated with periods of recession

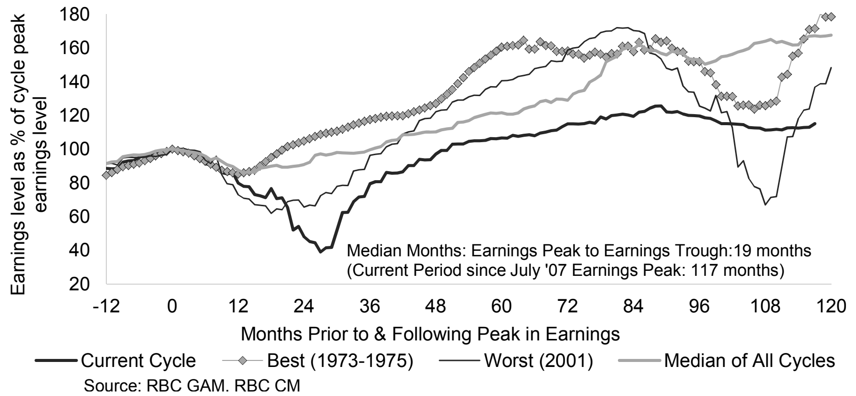


Exhibit 61: S&P 500 revenue

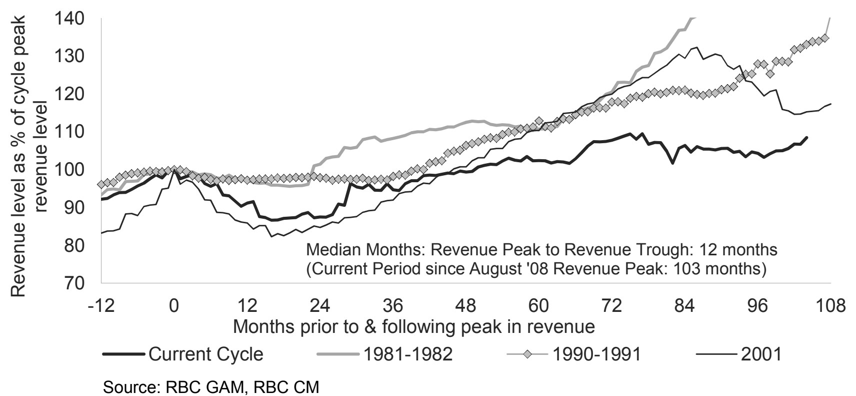
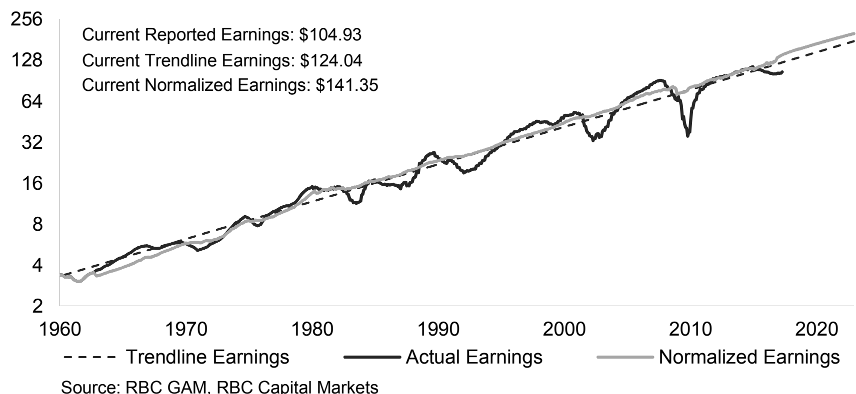


Exhibit 62: S&P 500 earnings comparison



surge to 2783.40 for an 18% total return over the next year and a half!

Style shift may indicate a loss of faith in Trump's economic plan

In addition to our aforementioned concern on valuations, another cause for concern is the reversal late last year of style trends that had signaled a pick-up in economic growth. Immediately following Trump's election win, small-cap and value stocks soared, as markets priced in better growth and inflation from large-scale tax cuts, deregulation and increased government spending. However, the reflation trade ended almost as soon as people began to label it as such. Since the beginning of this year, small-cap stocks have retraced 90% of their gains relative to large caps, and the gains that had accrued to value stocks relative to large caps have been wiped out since the election (Exhibit 66). Many investors have quibbled that the resurgence in growth is due to the FANG stocks (Facebook, Amazon, Netflix, Google), and while they certainly have contributed greatly to index returns, they account for only about one-third of the move in large-cap growth. The reversal in styles doesn't necessarily mean we will see a recession or a bear market, but it does signal that investors are no longer expecting the significant boost in growth and inflation that was initially anticipated after Trump's election win.

Exhibit 63: U.S. GDP and corporate profits
Corporate profit growth as a function of real GDP growth

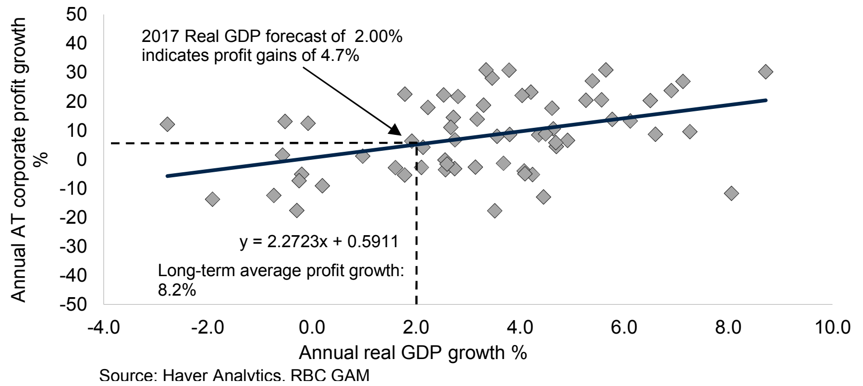


Exhibit 64: United States
S&P 500 revenue and nominal GDP

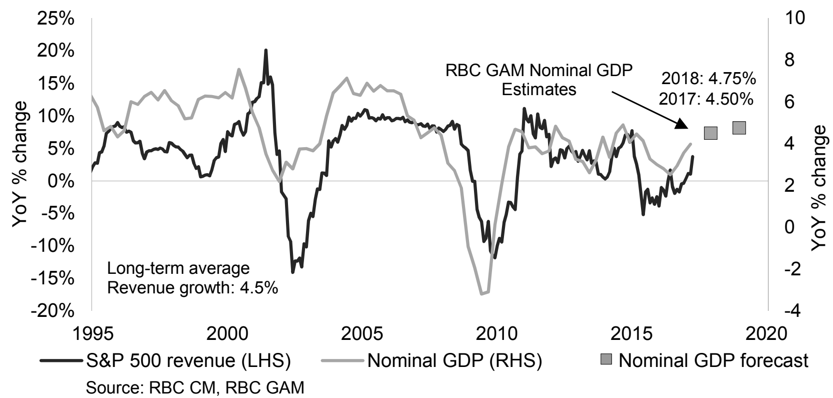


Exhibit 65: Earnings estimates and alternative scenarios for valuations and outcomes for the S&P 500 Index

		Consensus			
		2017 Top down	2017 Bottom up	2018 Top down	2018 Bottom up
	P/E	$131.8	$129.9	$147.3	$145.4
+1 Standard Deviation	23.2	3060.9	3017.7	3421.0	3376.9
+0.5 Standard Deviation	21.1	2775.6	2736.5	3102.2	3062.2
Equilibrium	18.9	2490.4	2455.2	2783.4	2747.5
-0.5 Standard Deviation	16.7	2205.1	2174.0	2464.6	2432.8
-1 Standard Deviation	14.6	1919.9	1892.8	2145.8	2118.1

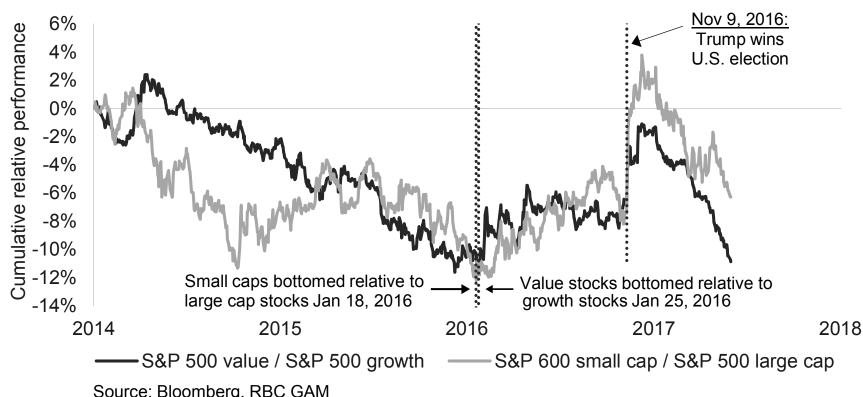
Source: RBC GAM

Asset mix – trimming equity overweight and maintaining underweight bonds

While the expected ramp-up in the economy following the U.S. election hasn't materialized, the economy is strong and we are seeing a global synchronized expansion underway. Sustained growth, even at a moderate pace, will allow the Fed to carry on with its gradual monetary tightening, and other central banks are likely to remove monetary accommodation as their economies continue to progress. The most notable risks to our outlook include protectionism, an aging business cycle and precarious geopolitics. That said, we expect the economy to weather these risks and run at a faster pace in 2017 than 2016, and to sustain the faster growth rate into 2018.

With modest growth in the economy and decent inflation, the outlook for sovereign fixed-income investments is bleak. Should the yield on U.S. 10-year bonds rise just 14 basis points from current levels, the capital loss will offset any coupon income earned over the next 12 months (Exhibit 67). Supporting our view that bond returns will remain low is the relationship between forward returns and current yields. Exhibit 68 illustrates that today's yield on 10-year Treasuries tends to predict what the return will be over the next 10 years. At current yields, prospective returns for bonds are extremely low or even negative. As a result, we remain underweight fixed income in our asset mix.

Exhibit 66: Relative style performance



Source: Bloomberg, RBC GAM

Exhibit 67: U.S. 10-year Treasury
Required move in yields for break-even return against 30-day T-Bill

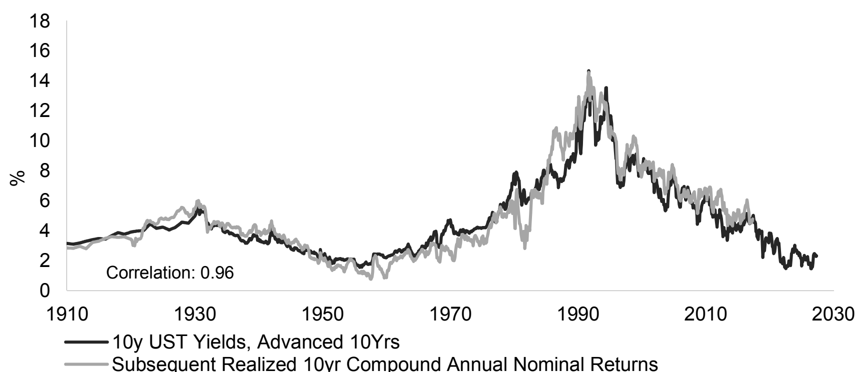
Source: RBC CM, RBC GAM

Prospective long-term returns for equities are much better than for bonds, although key signals have prompted us to reduce our degree of enthusiasm for stocks. The boost from expanding valuations in the U.S. may have run its course, particularly as interest rates continue to rise, meaning earnings growth will be critical to push equities higher.

While it is not our base case, stocks would be vulnerable to a correction should corporate profits fail to meet analysts' expectations. Additional points of concern are the extremely low levels of volatility, which may signal complacency, and the style rotation away from small cap and value into large-cap growth. We have been gradually reducing our equity allocation as stocks push through record levels, while maintaining an overweight stance. A few quarters ago, we had a 61% equity weight versus our strategic neutral of 55%. Earlier this year we pared that

by one percentage point and we are following that up by removing another one percentage point this quarter, moving the proceeds to cash. For a balanced, global investor, we currently recommend an asset mix of 59% equities (strategic neutral position: 55%) and 38% fixed income (strategic neutral position: 43%), with the balance in cash.

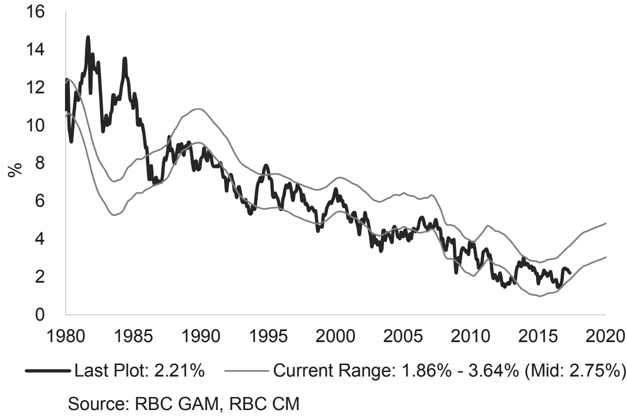
Exhibit 68: U.S. 10 year Treasury note and returns



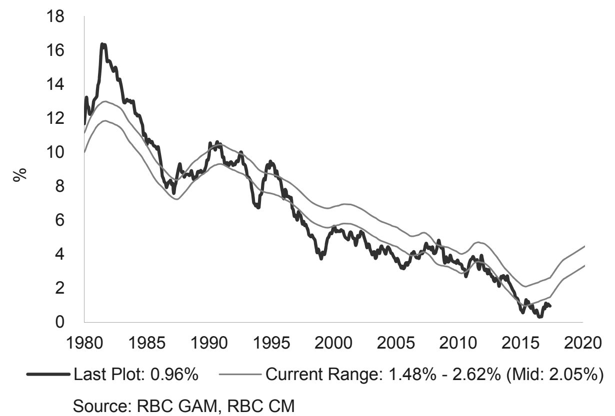
Source: Deutsche Bank, Haver Analytics, RBC Capital Markets

GLOBAL FIXED INCOME MARKETS

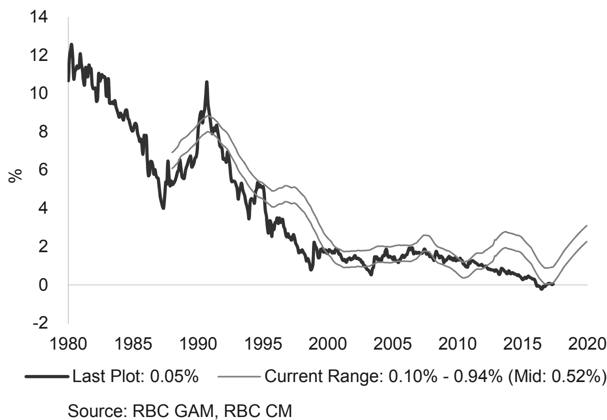
U.S. 10-Year T-Bond Yield
Equilibrium range



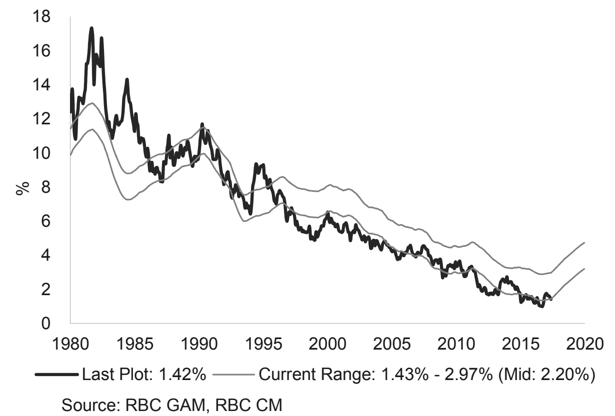
Eurozone 10-Year Bond Yield
Equilibrium range



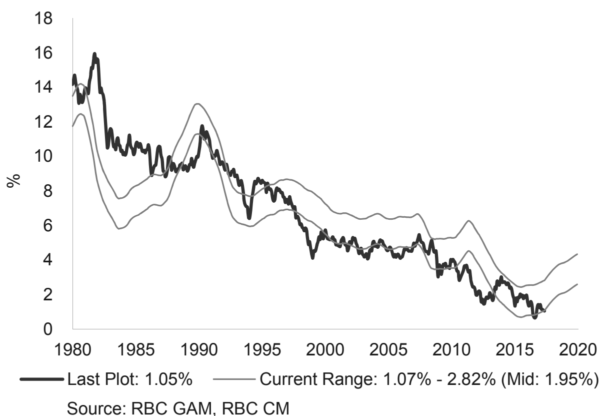
Japan 10-Year Bond Yield
Equilibrium range



Canada 10-Year Bond Yield
Equilibrium range



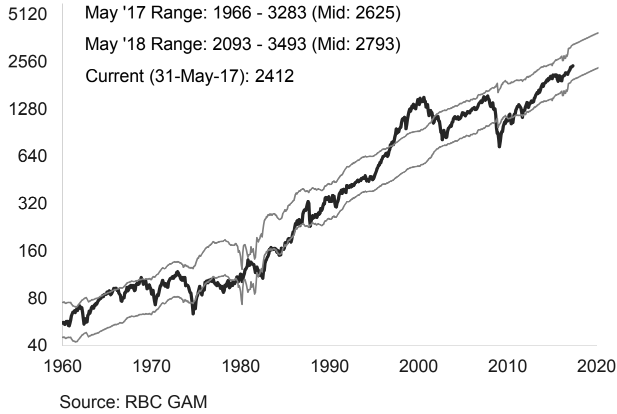
U.K. 10-Year Gilt
Equilibrium range



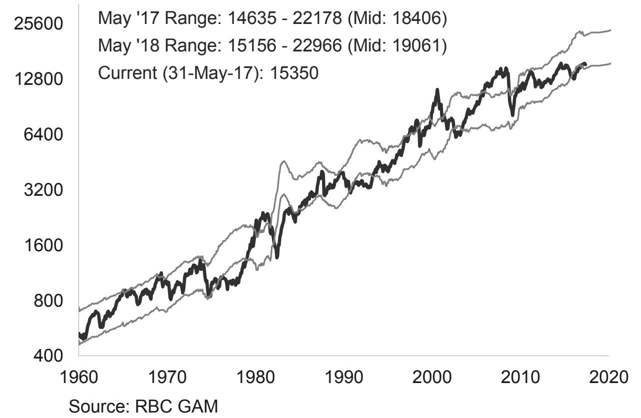
"Although the trend so far this year has been towards lower bond yields, our models continue to suggest that the long-term direction of yields is higher."

GLOBAL EQUITY MARKETS

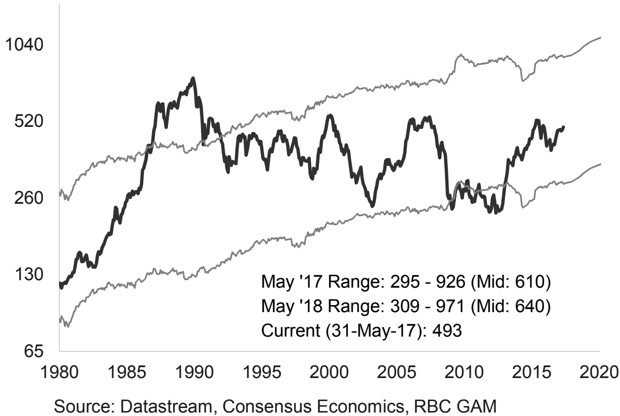
S&P 500 Equilibrium
Normalized earnings and valuations



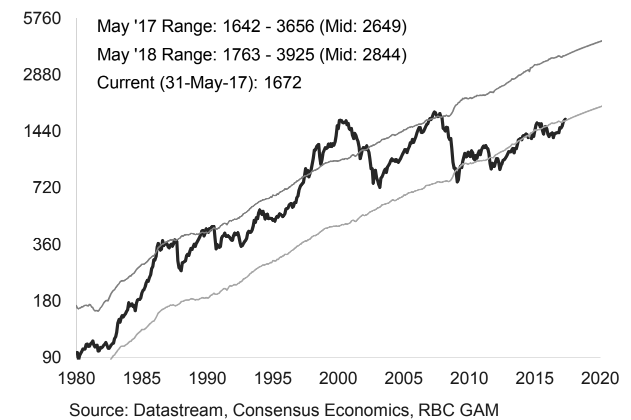
S&P/TSX Composite Equilibrium
Normalized earnings and valuations



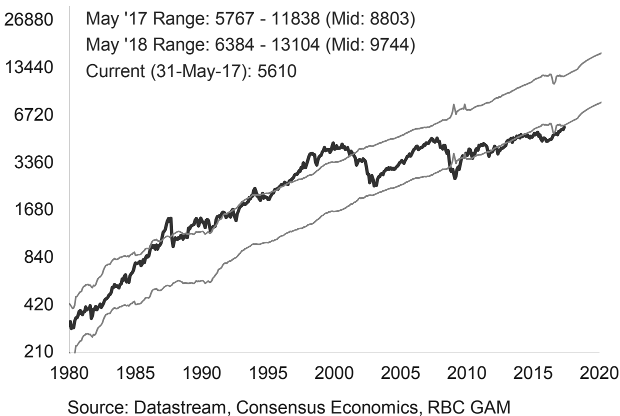
Japan Datastream Index
Normalized earnings and valuations



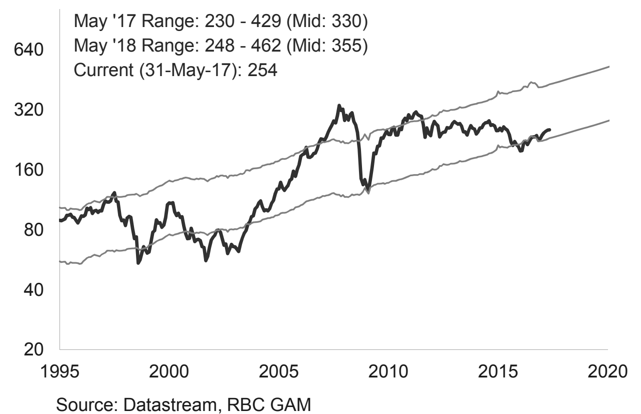
Eurozone Datastream Index
Normalized earnings and valuations



U.K. Datastream Index
Normalized earnings and valuations



Emerging Market Datastream Index
Normalized earnings and valuations



GLOBAL FIXED INCOME MARKETS

The bond-market outlook

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Suzanne Gaynor
V.P. & Senior Portfolio Manager
RBC Global Asset Management Inc.

Are global bond markets too complacent? That's the question being asked by investors concerned about issues including Donald Trump's presidency, impending changes to the make-up of the U.S. Federal Reserve's policy-making panel and the possibility that the three major central banks will all be tightening monetary policy in concert. These developments, taken together, could lead to higher yields within the forecast horizon. However, our thinking is that any uptick would be an overreaction, and, that when the dust settles, longer-term structural forces such as aging populations and highly indebted economies will likely prevent yields from straying much from the range that has been in place for about six years.

Let's start with Trump. Assume that, sometime this year, he succeeds in getting Congress to enact his proposed tax cuts, deregulatory measures and fiscal spending. Their passage would result in expectations of stronger economic growth and higher inflation, and, coupled with a smattering of trade protectionism, likely lead to higher bond yields and lower fixed-income returns. Two other possibilities exist: one is that Trump fails to sell legislators and the public on these policies. The other possibility is, of course, that Trump's tenure will be cut short, for whatever reason. In both cases, bond yields would likely fall.

The next task facing Trump is the possible appointment of a new Fed chairman, and the selection of as many as four of the remaining 11 members of the Federal Open Market Committee (FOMC). Investors are uncertain at this point whether the continuity that has characterized the Fed since the financial crisis will persist. Some analysts speculate that Trump is likely to choose appointees who are keen to abandon the Fed's commitment to keeping asset prices high and bond yields low – at least until the fruits of recovery are more evenly distributed. They worry that Trump will appoint FOMC leadership whose adherence to models might push up policy rates faster than warranted. Should the future FOMC choose to interpret the Fed's mandate on price stability and full employment differently, the pace of policy-rate hikes could pick up and the Fed's balance sheet could shrink more quickly than the market can digest. The result might be the worst outcome: an environment of rising bond yields and declining stock prices.

Yellen's four-year term as head of the FOMC expires in February, and three slots are empty following the April resignation of Governor Tarullo. Fischer's seat could also open up if he chooses to step down when his vice-chairman term expires in mid-2018. It is almost certain, therefore, that the FOMC will have a very different composition by this time next year. One possible replacement for Yellen is John Taylor, the Stanford University professor known for calibrating policy based more on economic statistics than the macroeconomic "big picture." A lack of obvious FOMC candidates and the absence of a clear frontrunner for chairman may create short-term volatility.

One risk of a reformulated FOMC is that the panel proceeds to reduce the Fed's balance sheet in a way that upsets financial markets. The prevailing view is that the Fed must move slowly in paring its US$4.5 trillion balance sheet to avoid rattling financial markets, and we expect the reduction to start at US$10 billion a month, or about 2.5% of the portfolio. But just because the Fed is talking about reducing its balance sheet, doesn't mean that it actually wants to do too much, or even needs to. After the 2008 banking crisis, global policymakers introduced regulations that, in effect, require banks to keep more money on deposit at the Fed, and those deposits are among the very assets swelling the Fed's balance sheet. That liquidity, as well as the natural growth of money in circulation, mean that the Fed's massive balance might

even be a semi-permanent feature of the financial system. We believe that a partial reduction in the Fed's balance sheet is manageable, but we fear investors might get spooked if the Fed moves too fast or explicitly states that it plans to offload most or all of the assets that it holds.

The balance sheets of the European Central Bank (ECB) and the Bank of Japan (BOJ) are also worth monitoring given that officials at both are discussing when and whether to slow their growth-supporting asset purchases. Europe's economy is again expanding and the threat of disinflation has eased, and BOJ officials feel it would be prudent to follow Europe's lead in scaling back the bank's bond buys, or at least to say they are considering it. With all three major central banks tightening policy at the same time, bond yields would be under pressure to rise. Our fear is that investors may not be ready for simultaneous monetary tightening, and that the initial reaction may be for yields to rise over the short term.

Another force that could push bond yields higher is the tenacity of the current economic expansion, which has given investors the confidence to favour risky assets over the safety of government bonds. The U.S. economy has plowed ahead, albeit slowly, even as doubts grow about President Trump's ability to win passage of his economic package, and economic statistics in Europe are on the upswing. Also supporting bond yields is Europe's success so far in avoiding the election of leaders opposed to further economic and political integration, specifically in France and the Netherlands. The same sentiment is reflected in rising support for Angela Merkel ahead of September elections in Germany.

We fear, however, that investors are overly confident that financial markets can continue to rise indefinitely. This calm is nicely illustrated in the skyrocketing popularity of passive investing, largely in stock-index funds, as trillions of dollars of central-bank stimulus has lifted all boats and encouraged investors to pay less attention to the underlying assets in which they invest. Investors are also largely ignoring the possibility that widespread anger generated by rising income inequality will mutate into destabilizing social unrest. These developments suggest that longer-term risks are under-priced, and that bond yields would surely plunge from already low levels were they to materialize.

To review, our forecast is for periodic spikes in bond yields over the next 12 months, presenting opportunities for investors to add bonds at more attractive rates. Accumulating government bonds at higher yields should produce better total returns as long-term structural forces will continue to hold yields down.

GLOBAL FIXED INCOME MARKETS

Direction of rates

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Over the past six years, U.S. Treasury yields have been trapped within a range, and calls for the death of the bond bull market continue to be wrong. We are sympathetic to the position that the bond bull, which started in the 1980s, must end at some point. However, the stabilization in yields should not be interpreted as foreshadowing a sustained rise. Our view is that bond yields could move sideways for an extended period, given the indebtedness of the global economy and banking-system regulations that are propping up demand for developed-market government bonds (Exhibit 1). In this environment, bond yields could temporarily break through the range, only to be pulled back within it.

In the shorter term, bond bears will be pleased that volatility is likely to be higher than it has been for many years. In the accompanying bond-market outlook, we cite the unpredictable behaviour of the Trump administration, impending changes to the make-up of the U.S. Federal Reserve's (Fed) policy-making committee and the possibility that the three major central banks will be tightening

Exhibit 1: U.S. 10-year yield has been trapped within a range over the last six years

Source: Bloomberg

policy simultaneously during our forecast horizon. As a result, bond yields could be prone to short-term surges of between 50 and 100 basis points.

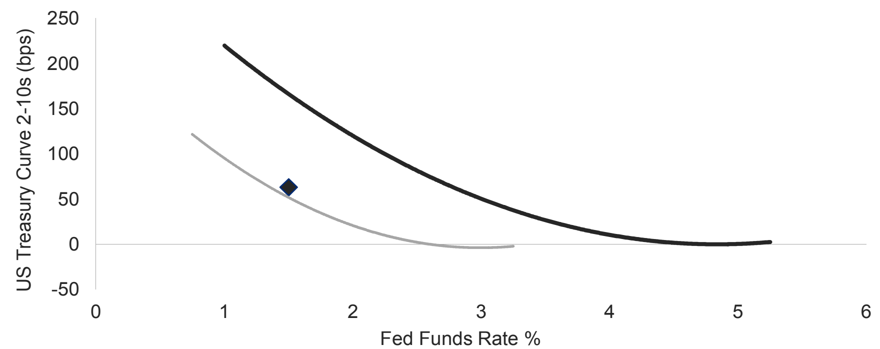
We are keeping our bond-yield forecasts largely unchanged and expect most central banks to consider tighter monetary policy as economic growth firms. The Fed is picking up the pace of monetary tightening and the European Central Bank (ECB) may scale back bond purchases heading into German elections in September. The Bank of Japan (BOJ) is likely to keep holding down the yield on the 10-year Japanese government bond (JGB) since inflation remains below its target, so don't take BOJ's musings about exiting quantitative easing too seriously. The Bank of England (BOE) will vary policy based on subdued growth and preparations for Brexit. The Bank of Canada (BOC) may hike once within our forecast horizon, reflecting the stronger global expansion.

U.S. – We expect the Fed to deliver three hikes in the fed funds rate over the next 12 months. The focus for the Fed will then shift to gradually reducing the amount of assets on its balance sheet. The gradual approach should prevent U.S. rates from rising much more relative to those in other major economies. This approach will also buy time for the Fed to assess the potential impact of any Trump fiscal-stimulus package and regulatory reforms to stoke inflation, and also for the Fed to assess the effect of higher rates on the overall economy. For more on the Fed's asset holdings, please see the article "The Federal Reserve's Balance Sheet" in this *Global Investment Outlook*.

Our expectation of future policy tightening is very similar to expectations currently priced in the market. Our models suggest

that the yield gap between 2-year and 10-year Treasuries will narrow to 65 basis points over the next 12 months from 100 basis points currently (Exhibit 2), and the yield curve should flatten as policy rates continue to rise. Our forecast is that the 10-year yield will rise to 2.50% sometime in the next 12 months, and in our view there is a risk that this rate trades above 3% before falling back to our forecast levels. The fed funds rate will rise to 1.63% from about 0.88% currently.

Exhibit 2: Yield curve is expected to flatten to 65bps from current the 95bps



Germany – The ECB bond-purchase program remains the factor holding down government-bond yields across Europe, as the central bank manages its assets around European elections. In the period leading up to the French presidential election, for example, the ECB acquired proportionately more French bonds than German bunds to prevent French yields from rising further versus those on German securities. We see the ECB continuing to use quantitative easing to manage financial stability across the Eurozone. Having said that, the brightening economic outlook in Europe means that the ECB may reduce the size of its bond-buying program by year-end, as bund yields should be higher. We expect ECB policymakers to keep the benchmark deposit rate at negative 0.40%, and our forecast for the 10-year bund yield remains unchanged at 0.75%.

Japan – The BOJ may become more flexible with policy, which centers on controlling the yield curve, as Treasury yields rise and the ECB prepares to pare the pace of bond purchases. With global growth continuing at its recent pace, we expect the BOJ to keep its official target on the 10-year JGB at 0.00%, but to allow it to stray higher to 0.10%. We maintain our deposit-rate forecast at negative 0.10%.

Canada – The Canadian economy has had a strong start to the year, enough so that BOC Governor Poloz has said that further rate cuts are unlikely for now. However, Poloz warned that the impact of any protectionist trade policies proposed by the U.S. could have a significant negative impact on growth. The other focus continues to be household indebtedness and the overheated Toronto housing market. The Ontario government announced measures in April aimed at ending speculation and relieving longer-term supply shortages. We don't expect policy rates to start rising until at least mid-2018, when the BOC estimates the output gap will close.

International investors continue to seek out Canadian bonds given that Canada is one of only a dozen countries with a AAA credit rating and that its political and financial backdrop is relatively stable. The comfort level for foreign investors has led to a shift from the safest Government of Canada securities to the extra yield offered by the provinces. This strong foreign demand lines up nicely with the increased funding needs of the provinces and allows for issuance outside of Canada, most recently in U.S. dollars, euros and Australian dollars. This year is shaping up as the biggest ever for provincial bond issuance. The record, C$27 billion in 2009, was due to investors scrambling for high-quality securities during the credit crisis. Today the demand stems from the fact that quantitative easing in Europe and Japan is leading investors to seek higher yields elsewhere.

Canadian bonds have outperformed Treasuries since the start of the

year. This makes sense as the BOC is likely to keep the policy rate unchanged at 50 basis points for most of the year, while investors are pricing in tightening by the Fed. Lower oil prices and housing-market concerns support the BOC's preference for staying put on rates. We note that the relationship between the price of oil and the direction of interest rates has generally been highly correlated, but is less so now. For longer-term maturities, valuations of Canadian securities now seem stretched.

We are forecasting a 25-basis-point increase in the BOC policy rate to 75 basis points late in our 12-month horizon. However, our 10-year government bond forecast is unchanged at 1.75%.

U.K. – Recent data suggest that inflation is ebbing after the Brexit vote led to a series of higher-than-desired readings caused by a plunge in the pound. Attention is shifting from currency effects to prospects for economic growth and the impact of Brexit negotiations following last week's general election. The BOE is standing by to support the economy given that businesses are delaying investments amid uncertainty about the U.K.'s relationship with its biggest trading partner, the EU. Further significant softening in investment sentiment, economic activity and consumption could prompt the BOE to deliver another round of easing in 2018. For the time being, we expect the BOE to maintain the status quo by

INTEREST RATE FORECAST: 12-MONTH HORIZON
Total Return calculation: May 31, 2017 – May 30, 2018

U.S.

	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	1.63%	1.85%	2.25%	2.50%	3.10%	0.29%
Change to prev. quarter	0.25%	0.10%	0.25%	0.00%	0.00%	
High	1.88%	2.50%	3.00%	3.25%	3.75%	(3.37%)
Low	0.88%	0.90%	1.25%	1.60%	2.30%	5.60%
Expected Total Return US$ hedged: 0.45%						

GERMANY

	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	(0.40%)	(0.10%)	0.20%	0.75%	1.30%	(1.98%)
Change to prev. quarter	0.00%	0.00%	0.00%	0.00%	0.00%	
High	0.00%	0.50%	0.80%	1.25%	1.60%	(5.66%)
Low	(0.40%)	(0.50%)	(0.25%)	0.00%	0.50%	5.97%
Expected Total Return US$ hedged: (0.16%)						

JAPAN

	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	(0.10%)	(0.05%)	(0.07%)	0.10%	0.95%	(1.00%)
Change to prev. quarter	0.00%	0.05%	(0.02%)	0.00%	0.00%	
High	0.00%	0.10%	0.10%	0.25%	1.10%	(3.05%)
Low	(0.10%)	(0.10%)	(0.10%)	(0.10%)	0.60%	3.45%
Expected Total Return US$ hedged: 0.82%						

CANADA

	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	0.75%	1.00%	1.25%	1.75%	2.30%	(0.67%)
Change to prev. quarter	0.25%	0.10%	0.10%	0.00%	(0.10%)	
High	1.25%	1.65%	1.90%	2.35%	2.85%	(5.46%)
Low	0.25%	0.25%	0.40%	0.90%	1.60%	6.34%
Expected Total Return US$ hedged: (0.51%)						

U.K.

	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	0.25%	0.30%	0.75%	1.25%	2.00%	(2.34%)
Change to prev. quarter	0.00%	(0.30%)	(0.25%)	(0.25%)	(0.25%)	
High	0.50%	1.00%	1.50%	2.00%	2.50%	(9.28%)
Low	0.00%	0.00%	0.25%	0.50%	1.40%	6.49%
Expected Total Return US$ hedged: (1.09%)						

Source: RBC GAM

keeping its policy rate at 0.25%, and we decrease our 10-year gilt yield forecast to 1.25%, a 25-basis-point drop.

Regional preferences

We are changing our regional recommendation to underweight German bunds by 5 percentage points, up from a 2.5-percentage-point underweight last quarter, and move to neutral on JGBs from a 2.5-percentage-point underweight. Our overweight on U.S. Treasuries remains at 5 percentage points. We expect bund yields to rise more than those on U.S. Treasuries as investors gradually price in the possibility that the ECB will begin its exit from quantitative easing toward the end of the forecast horizon.

GLOBAL FIXED INCOME MARKETS

The Federal Reserve's balance sheet

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As the U.S. Federal Reserve continues to gradually raise interest rates from historically low levels, the market's attention is now turning to the next phase of the policy-normalization process: balance-sheet reduction. We expect this process to begin in late 2017 or early 2018. In this section, our Fixed Income Strategy Committee lays out its view on why management of the Fed's balance sheet is important for investors, and how the Fed will likely proceed.

A short history of the Fed's balance sheet

Before we speculate on what the Fed's balance sheet will look like in the future, it is important to touch on its historical role. Prior to the global financial crisis and quantitative easing, the balance sheet was not used as an active policy tool by the Fed. Instead, the assets held were determined mainly by the public's demand for currency, which was itself largely a function of economic growth.

As a direct result of the Fed's unconventional monetary-policy actions taken in the aftermath of the financial crisis, the balance sheet is now substantially larger than what demand for currency would imply. Absent reductions in the size of the balance sheet, this will remain the case for some time into the future. In fact, if the Fed left its balance sheet unchanged, currency demand would not "catch up" to the balance sheet's current size until around 2035.

The Fed's future balance sheet

It is not clear, however, whether the Fed can or should return to pre-crisis conditions given how much the banking system has changed over the past decade. Capital requirements for banks are much higher than they were before the crisis, and we believe that this translates into a need for the Fed to maintain a large balance sheet indefinitely.

The single most transformative regulatory change in the aftermath of the financial crisis has been the amount of capital that banks must hold against short-term liabilities such as deposits. Before the crisis, banks were only required to hold capital against deposits in the U.S and this capital was held as required reserves at the Fed. Crucially, these U.S.-based deposits then, as now, represented only a fraction of the banking system's total short-term liabilities. At the time, this cushion was not considered problematic as banks would routinely tap additional sources of funding from financial markets.

This situation changed during the financial crisis, which resulted in a global shortage of liquidity as the capital held by banks against short-term liabilities proved to be grossly insufficient. As a result, global regulatory efforts have strived to improve banks' liquidity buffers by matching their short-term liabilities with high-quality liquid assets that can be used to meet unanticipated liquidity shortfalls. Instead of only having to hold capital against U.S.-based deposits, banks must now hold high-quality liquid assets against all global short-term liabilities that expire in fewer than 30 days. These capital requirements far exceed the amount of required reserves held by banks in the pre-crisis years. To get an idea of the size of this change in capital needs, required reserves prior to the crisis were around US$100 billion. Now, these holdings of high-quality liquid assets amount to nearly US$4.5 trillion.

This increase in capital requirements informs our estimate of what the normal size of the balance sheet should be as the Fed, through its massively expanded balance sheet, is providing what might be considered the safest and most liquid asset in the world: reserves. Indeed, reserves form a substantial portion of the banking system's high-quality liquid assets. Going forward, banks may prefer to hold these reserves as their primary liquidity buffer, as the use of reserves to meet unanticipated liquidity shortfalls entails next to no disruption to bank or market operations if used as such. This

is in contrast to other assets that would also satisfy regulatory capital requirements – primarily U.S. government bonds and mortgage-backed securities. We believe that the Fed may also prefer to maintain a larger balance sheet, as doing so will enable the central bank to satisfy an ancillary policy goal of bolstering financial stability.

In summary, due to regulatory changes and banks' preference to use reserves as liquid assets, the Fed's balance sheet may be permanently larger. In addition to demand for currency, the size of the balance sheet will also include demand for reserves.

What to expect

There are three critical elements to the Fed's plans to reduce the size of its balance sheet: when the reduction will start; the pace; and what the Fed will consider the appropriate amount of assets to hold at the end. From public comments as well as published guidance, we know a fair amount about the first two aspects, while the third one is more nebulous.

In terms of timing, the Fed has long maintained that it would address the size of its balance sheet after the normalization of interest rates was well underway. With the Fed funds rate now about halfway towards its median estimate of the long-run neutral policy rate of 2.75%, balance-sheet reduction is in the offing. Indeed, in the May minutes of the Federal Open Market Committee, board members indicated that they would like to begin reducing the size of the Fed's balance sheet by the end of this year.

We know that the Fed is going to use the maturity schedule of its holdings of U.S. government bonds and mortgage-backed securities to facilitate the reduction of the balance sheet. However, the rate at which the Fed's holdings will naturally mature is highly uneven. The Fed will control this by designating a set pace of balance-sheet reduction, which we believe will likely start at US$10 billion per month and be comprised of U.S. government bonds and mortgage-backed securities, in order to allow the Fed to test the ability of the market to absorb the increased supply of bonds. From the May minutes, we also know that the planned pace of reductions and any changes will be both publicly announced and gradually increase. The Fed does not anticipate altering its balance-sheet policy unless there is a significant change in the economic outlook, according to the minutes.

In contrast to timing and composition, the Fed has released relatively little information regarding what the long-term size of the balance sheet will be. This likely reflects the wide range of opinions among members of the FOMC. What we do know is that the Fed has demonstrated that its framework for controlling interest rates, while maintaining a large balance sheet, works effectively. Overall, given the lack of consensus on the terminal size of the balance sheet, and reflecting the Fed's gradual approach to normalizing interest rates, we expect the shrinkage to proceed fairly slowly and be completed over several years.

In summary, we believe that the eventual reduction of the Fed's balance sheet will be very gradual, mirroring the approach that the central bank has taken to raising interest rates over the past 18 months. Moreover, the amount of re-sizing may be more limited than many think, given changes to the banking system over the past several years.

CURRENCY MARKETS

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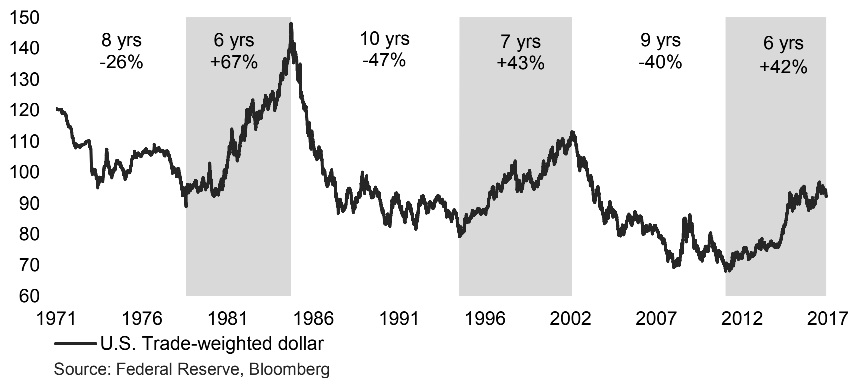
Our belief that the U.S. dollar would strengthen has been firmly in place for several years. While this is still the case, our message is becoming more nuanced. Our forecasts remain tilted toward outperformance of the greenback, but each passing month of U.S. dollar strength adds to a maturing currency cycle and implies a higher probability that the U.S. dollar peak will occur within our 12-month forecast horizon. It's even possible that the peak is already behind us, although we don't assign high odds to that turning out to be true. For now, our dominant scenarios still consider this cycle unfinished.

Our base case is for the peak in the U.S. dollar to occur at some point beyond our 12-month horizon. Our forecasts for currency weakness are intentionally less aggressive for the time being, recognizing the higher uncertainty in predicting when the U.S. dollar will reverse course. Our expectation is that this topping process will take time, unlike prior peaks in 1985 and 2001, which were prompted by global policymakers' abrupt efforts to counter the threat to economic stability from rapid and uncontrolled U.S. dollar strength. Today, we have yet to see destabilizing currency fluctuations. In fact, exchange-rate volatility currently sits at its lowest level in several years (Exhibit 1).

Exhibit 1: Bloomberg Currency Volatility Index

Exhibit 2: Trade-weighted USD index



Our evaluation of the currency outlook begins with a review of the long-term cycles in the U.S. trade-weighted dollar. These are critical because they help define the investing landscape and often dictate the direction of individual currencies. Looking at these cycles (Exhibit 2), we see that the current upswing in the U.S. dollar has now matched the typical bull cycle in length (6-7 years) and magnitude (40%-60%). The U.S. dollar cycle often reflects trends in economic growth and interest rates in which higher levels of both relative to trade partners will drive strength in the greenback. This cycle is no exception – American economic outperformance has fuelled huge

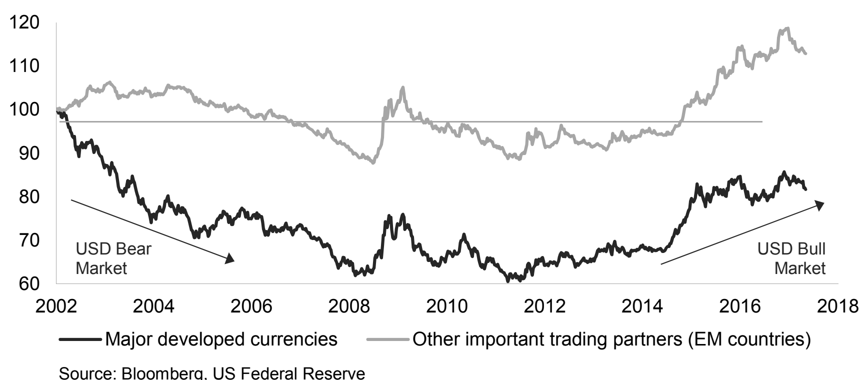
demand for the U.S. dollar and the U.S. Federal Reserve's (Fed) three interest-rate hikes over the past year and a half have lent support to the currency with more attractive yields than elsewhere. A host of other factors continue to support the U.S. dollar, including:

- a slowdown in the growth of global foreign-exchange reserves, which limits the need to diversify holdings into other reserve currencies like the yen, euro and pound.
- the current-account deficit is quite small relative to what it has been at prior U.S. dollar peaks.
- expected repatriation of corporate earnings held abroad resulting from tax-policy changes in the U.S., and
- the safe-haven status of the greenback

We also note that the U.S. dollar is not extremely overvalued even after six years of gains. Historically, currencies diverge from fair value by at least 20% before prompting significant and broad-based changes in economic decision-making – such as moving factories or deciding to shift purchases toward imported substitutes. On a trade-weighted basis, and also relative to most individual currencies, the U.S. dollar has not yet reached such a level of overvaluation.

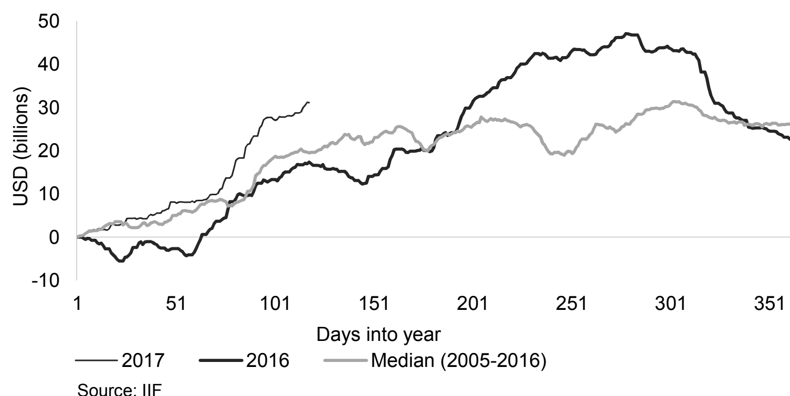
When we weigh all the elements driving currency markets, we still see a greater number of supportive factors for the U.S. dollar. However, we acknowledge that many of the positives have been priced in to some extent, while the negatives are beginning to stack up against the greenback.

Exhibit 3: U.S. trade-weighted dollar weakness
Indexed to 100 on Jan. 31 2002 (start of last USD bear market)



Source: Bloomberg, US Federal Reserve

Exhibit 4: Emerging-market portfolio flows
Cumulative, YTD



Source: IIF

Emerging-market currencies

It's important to distinguish U.S. dollar strength against developed markets from its strength versus emerging-market currencies. Even as developed-market currencies weaken, emerging-market ones are likely to remain resilient. Exhibit 3 shows the U.S. dollar indexed separately against these two subsets over the last full currency cycle. The greenback suffered much larger losses against developed-market currencies during the 2002-2011 U.S. dollar bear market, and so it should naturally have more to gain against them as weakness is reversed. Yet the U.S. dollar has also strengthened substantially against emerging-market currencies over the past few years on concerns

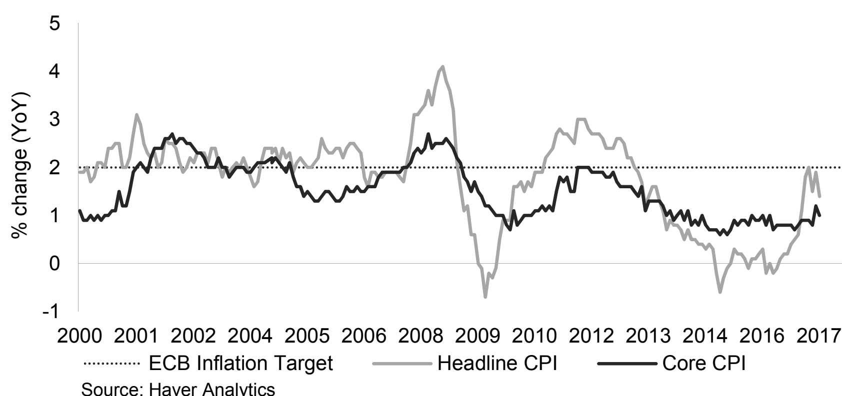
about slowing growth in China; Fed rate hikes; geopolitical worries; as well as corruption scandals and inept governments in countries such as Brazil. But, as investor fears are assuaged by the Fed's gradual approach and improvements in China, the world's second-largest economy, emerging-market currencies have begun to gain traction. While public shows of curbing corruption indicate that corruption exists, such actions can actually be a positive sign since they represent efforts to tip the scale toward greater accountability.

Stronger economic growth and higher yields relative to developed economies, combined with still inexpensive currencies, have underpinned capital flows into emerging-market assets, amounting to an impressive US$30 billion during the first four months of 2017, almost double that of the equivalent period last year (Exhibit 4). These inflows reflect that emerging-market assets and currencies are showing some immunity to negative headlines. Even highly uncertain events like the French elections, the Turkish referendum on increasing presidential power and the rising frequency of North Korean missile tests have done little to temper risk-on sentiment.

Euro

Our bearish stance on the euro has been among our most firmly held views. We still believe the single currency may test parity with the U.S. dollar within the forecast horizon, but have revised our 12-month forecast to 1.02. This change recognizes a slightly better outlook for the euro in line with the aging U.S. dollar cycle and improving European fundamentals. Political risk, for instance, has fallen markedly with the election of pro-European Macron in the French presidential election and the Dutch rejection of more extreme political options in March elections. A large part of the fundamental improvement can also be attributed to a strengthening of economic data in the Eurozone, where our growth forecasts are slightly higher than consensus. This strength is not confined to core European countries. Indexes of economic sentiment are rising in peripheral countries too, while lending activity firms and employment continues to exceed European Commission estimates. The outlook for certain individual countries is still troubled: the main Italian populist party is essentially tied in the polls with the incumbent centrist party, but improvement in growth dynamics for the Eurozone as a whole cannot be ignored.

Exhibit 5: ECB inflation measures below target



Source: Haver Analytics

The most important factor for the euro is the continued divergence in monetary policy between the European Central Bank (ECB) and the Fed. The gap in interest rates determined by the two central banks will continue to widen in favour of the greenback even if the ECB reduces the size of its monthly round of quantitative easing. We expect that ECB President Mario Draghi will keep rates on hold for at least the next 12 months. Unlike the Fed, the ECB has only a single mandate – price stability. So, even with a steady and gradual economic recovery, the ECB is unlikely to be swayed as long as underlying inflation in the region remains weak. Overall inflation had been rising earlier in the year, but this was the result of a transitory boost from energy prices and prior currency weakness. Core measures of price changes, which exclude these effects, remain well below the

ECB's 2% mandate (Exhibit 5). We can recall two separate occasions, in 2008 and 2011, where the ECB hastily raised interest rates in reaction to surging oil prices and temporary high headline inflation. Both cases subsequently resulted in an embarrassing reversal when economic growth faltered and the central bank was forced to subsequently cut rates. Amid similar conditions today, we believe that the ECB will be wary of committing a similar policy mistake. Indeed, Draghi has already firmly rejected the notion that rates could be increased before quantitative easing is stopped. This supports our belief that monetary-policy divergence can still drive further euro weakness.

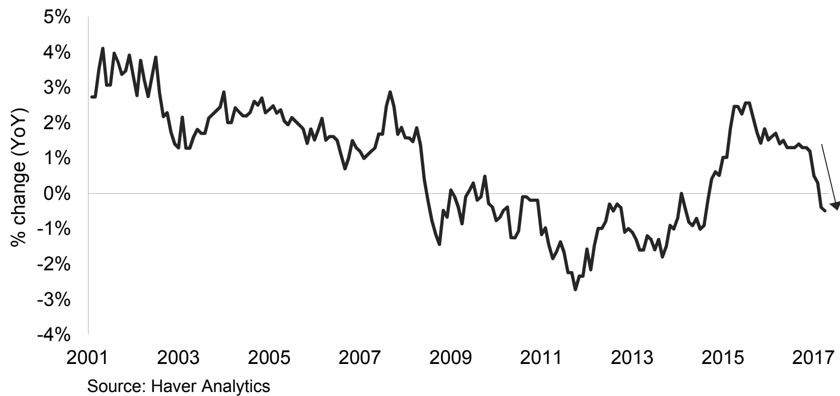
British pound

As Britons headed to the polls last week, investors were squarely focused on U.K. politics. Theresa May's unexpected call for an election brought a lot of hope that the U.K. may avoid a disorderly departure from the EU. Those concerns aside, we caution that recent data proves that economic malaise appears to have already set in. Consequently, the pound has quickly become one of our favoured shorts, and our 1.15 forecast implies a larger depreciation of the pound than of other developed-market currencies.

We are primarily concerned about weak consumer spending in an economy that is driven 60% by consumption. The fall in the pound last year has caused prices to rise on imported items, many of which don't have domestically produced substitutes. In addition, employment growth is weak and wage growth hasn't kept up with inflation (Exhibit 6). These trends reduce the disposable income available for spending on domestically produced goods and services. Households are now forced to either save less or borrow more in order to maintain their spending habits. In fact, both of these developments are occurring (exhibits 7 and 8) and both represent an unsustainable trend of borrowing from future consumption.

Another ongoing issue we have with the pound is the U.K.'s large current-account deficit – an outflow of capital that continues to worsen and is now the largest among the countries we follow. To date, this funding requirement has been more than covered by a healthy appetite for U.K. assets by foreigners. Analysis by Deutsche Bank shows that much of these inflows have

Exhibit 6: U.K. real wage growth



Source: Haver Analytics

Exhibit 7: U.K. consumers already borrowing to sustain consumption

Source: BOE, Macrobond

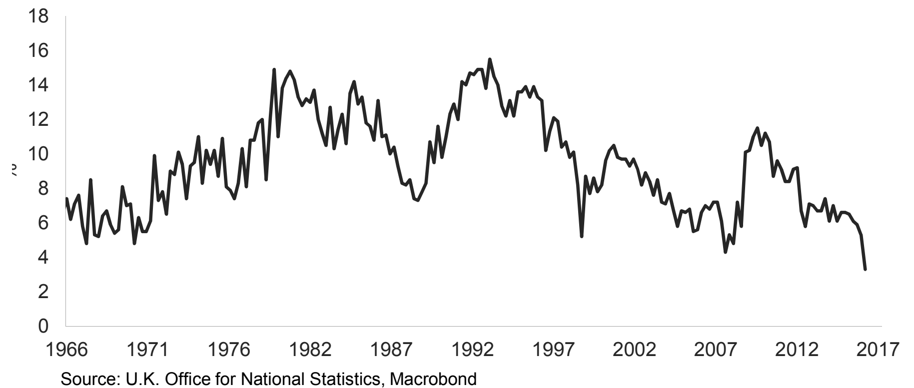
come from European investors who, discouraged by negative rates and quantitative easing at home, parked their money in higher-yielding U.K. government bonds instead. Eventually, this could become a major problem for the pound as the ECB reduces the pace of quantitative easing. In any event, a cheaper currency may be just the tool needed to attract foreign purchases of U.K. assets.

Japanese yen

In this environment of broad U.S. dollar strength, we find ourselves less concerned about yen weakness, in part because the currency is relatively cheap. According to our purchasing-power-parity metric (Exhibit 9) and most other valuation measures we follow, the yen is among the most undervalued currencies in the developed world.

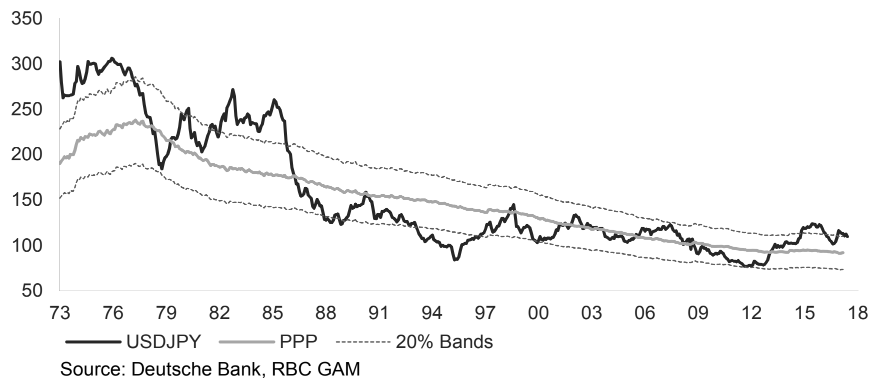
Moreover, we don't expect the yen's other traditional drivers to exert meaningful downward pressure on the currency. Interest-rate differentials have historically been the primary determinant of yen fluctuations, but unlike the euro and other major currencies, the yen has been more heavily influenced recently by differences in longer-term, not shorter-term, yields. And, with the Bank of Japan (BOJ) having committed to keeping 10-year yields between 0% and 0.1%, we are left with a currency that is almost entirely driven by changes in U.S. government-bond yields (Exhibit 10). Our fixed-income specialists expect the yield on the 10-year Treasury

Exhibit 8: U.K. – Household-savings rate



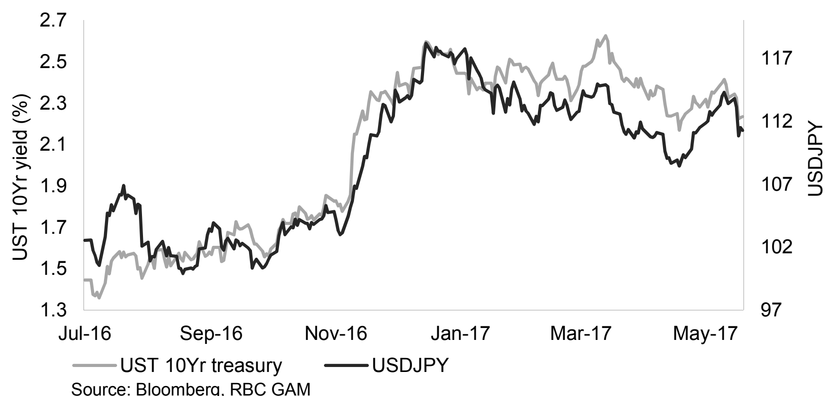
Source: U.K. Office for National Statistics, Macrobond

Exhibit 9: USDJPY: Purchasing-power-parity valuations



Source: Deutsche Bank, RBC GAM

Exhibit 10: JPY moves are now driven by U.S. yields



Source: Bloomberg, RBC GAM

bond to rise only slightly, and this expectation is consistent with our forecast for only moderate yen weakness.

The Japanese currency is now near the middle of its three-year range between 100 and 120 per U.S. dollar (Exhibit 11). Given the low levels of foreign-exchange volatility and the anchoring of longer-term yields through BOJ monetary policy, we think it reasonable for this trading range to be maintained. The investment activity of domestic investors further supports this thesis. Reports by Nomura and Mizuho suggest that all nine of Japan's major life insurers have increased allocations to foreign bonds and plan to add more in 2017, with the amount and pace of this outward investment quite significant (Exhibit 12). Importantly, some of these foreign assets are unhedged, so buying of assets overseas does exert downward pressure on the yen. However, we would not expect the yen to weaken much beyond 120 because Japanese institutional investors are likely to start buying back the yen if it reaches that level.

Canadian dollar

There is no shortage of negative factors weighing on the Canadian economy and the Canadian dollar. One of those is the severe reduction in manufacturing between 2006 and 2013, when the loonie was exceptionally strong. The fact that our trade balance has not yet recovered is evidence of lost competitiveness relative to the

Exhibit 11: JPY trading in the 100-120 range

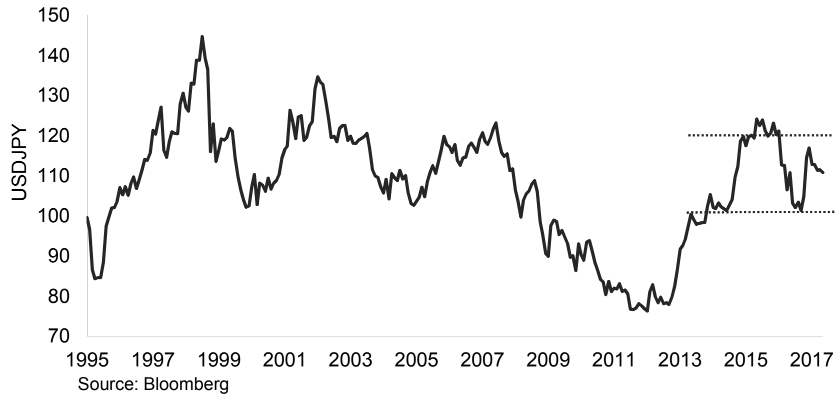


Exhibit 12: Foreign securities held by Japanese life insurers

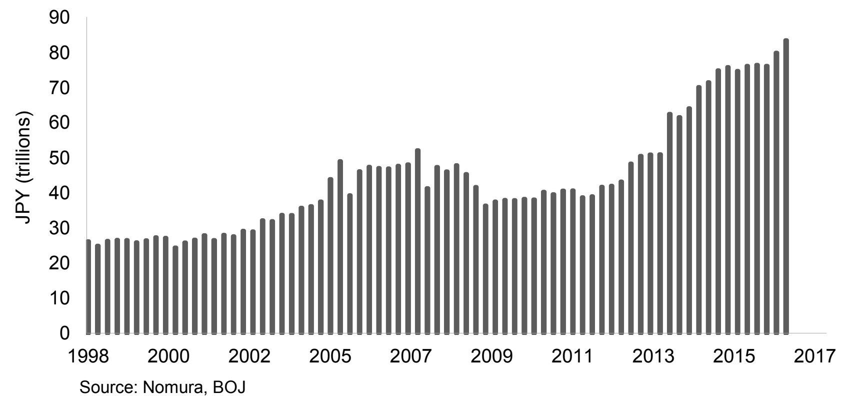
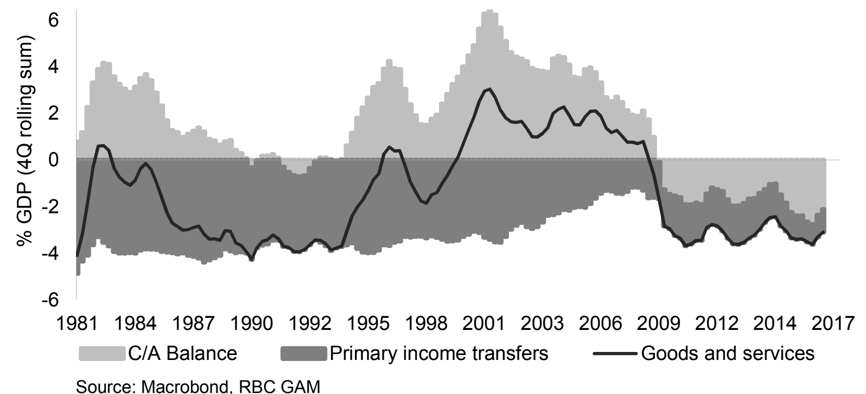


Exhibit 13: Canada current-account balance

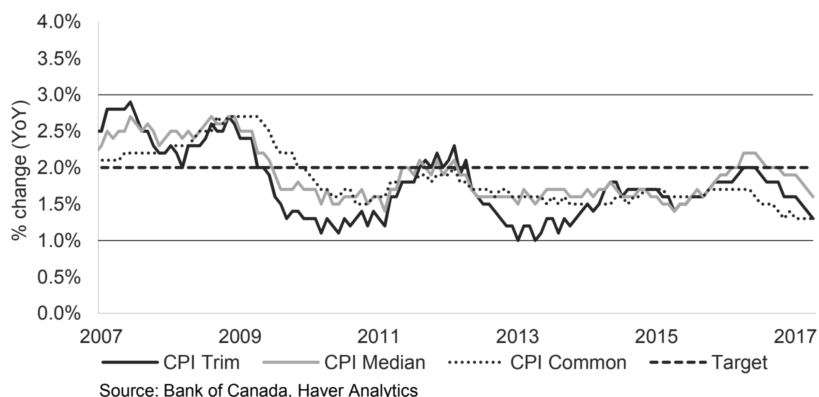


U.S., Mexico and other trade partners. While a weaker loonie is seen as a necessary ingredient for a manufacturing revival, we believe that goods trade will never fully regain its standing as a major contributor to Canadian economic growth. Reflective of this reality is Canada's persistent current-account deficit (Exhibit 13), which, at over 3% of GDP, exerts a continued downward influence on the loonie.

Monetary-policy divergence also weighs on the currency. While the Fed gradually raises short-term interest rates toward more neutral levels, the Bank of Canada (BOC) remains firmly on hold. All three of the BOC's measures show that core inflation is well below the central bank's official 2% target and is also trending lower (Exhibit 14). Recent speeches by BOC Governor Poloz suggest concern about weak exports and the very tentative improvements in business investment. Poloz's somewhat dovish stance translates directly to a weaker Canadian dollar in the form of relatively unattractive yields.

A discussion on the Canadian dollar cannot omit Canada's obvious connection to commodities. Even with the deflating of the oil-sands craze, commodities remain an important element to consider for the currency's outlook. On this note, the recovery of crude prices from their nadir early last year has been welcomed by the western provinces. However, the recent bounce is hardly game-changing for the country's producers, many of which have break-even costs that are higher than the current oil-price range of US$45-US$55 per barrel. Recent commitments by OPEC to retain supply reductions until March 2018 should keep oil prices afloat in the short term, but we remain skeptical that these efforts can have much of a lasting impact given the increasingly agile and competitive nature of U.S. shale producers. Without even more innovative ways to improve the oil-sands extraction process, the degree to which resources can contribute to economic growth is limited.

Exhibit 14: Canada inflation measures



Source: Bank of Canada, Haver Analytics

A more recent issue for Canadian oil producers is that new governments in Alberta and British Columbia are not friendly to the industry. Those governments are increasingly resistant to further development in the oil sands and to pipeline construction. In addition to the difficulties posed by high extraction costs, oil producers must now also deal with emission caps and increases in carbon taxes. Some producers, many of whom are foreign players, have chosen instead to simply sell their Canadian oil-sands assets. This is a theme worth following for currency investors, as it represents a potential capital outflow on the order of tens of billions of dollars.

More recently, it is fears about hot housing markets in Toronto and Vancouver that have begun to negatively affect the exchange rate. While relatively high prices and low affordability are not new, troubles at a small lender brought fears of a housing-market collapse back to the fore. The housing concerns, coupled with protectionist tariffs slapped on Canadian lumber by the Trump administration, temporarily pushed the U.S. dollar up through the high end of the well-entrenched 1.30-1.36 range. We don't believe that housing is on the verge of collapse or that protectionist measures will dominate headlines forever, but we do acknowledge that these

developments add to the list of Canadian-dollar negatives weighing on performance during the final stages of U.S. dollar strength. Our forecast is for the Canadian dollar to weaken to 1.44 per U.S. dollar.

To conclude

Currency forecasting is a dangerous occupation at the best of times, but particularly so during the inflection points of the cycle. The average U.S. dollar cycle is seven years long, and prior phases of strength and weakness have ranged from five to 10 years. We are more cautious than we were because of the maturing U.S. dollar cycle and the possibility that negative factors are playing a larger role. There remain, however, valid reasons why this cycle could extend beyond the average, and they don't require heroic assumptions about dollar-friendly Trump policies. Growth differentials, monetary-policy divergences, a historically low current-account deficit and only moderate overvaluation are among the reasons for staying bullish on the U.S. dollar.

REGIONAL OUTLOOK – U.S.

Brad Willock, CFA
V.P. & Senior Portfolio Manager
RBC Global Asset Management Inc.

The U.S. stock market made progress over the three-month period, rising 2.6% as the economic expansion continued. Strong performances from the Information Technology and Consumer Discretionary sectors powered the advance, while returns in the Energy, Telecommunication Services and Financials sectors were a drag. As has become typical, the period featured aggressive rotation among sectors and investment styles as U.S. growth slowed, interest rates and inflation moved lower, and the likelihood of significant tax reform, infrastructure spending and regulatory overhaul seemed to dwindle.

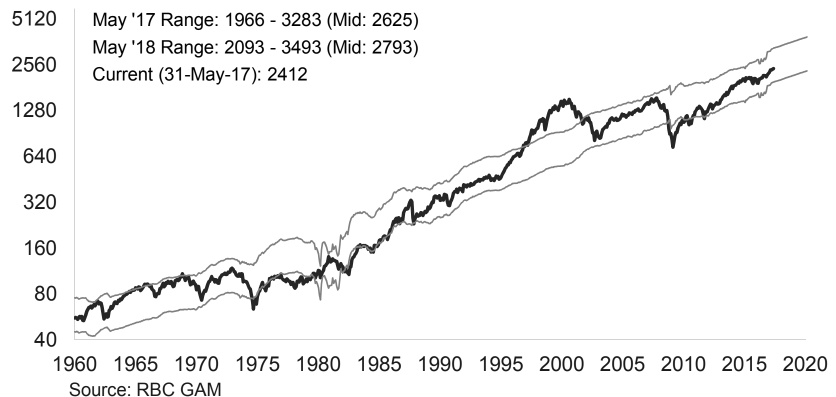
The market was led in the latest quarter by areas that could be characterized as either growth-oriented (Information Technology and Consumer Discretionary) or defensive (Utilities and Consumer Staples), and returns were concentrated in a narrow group of high-growth companies. In fact, the Information Technology sector plus Amazon and Netflix, which are Consumer Discretionary stocks, generated roughly two-thirds of the S&P 500's gain between January and May. A state of affairs where growth-oriented or defensive stocks outperform value-oriented stocks is typical of an environment where the rate of improvement in economic activity is slowing. However, we suspect that the style

UNITED STATES RECOMMENDED SECTOR WEIGHTS

	RBC GAM INVESTMENT STRATEGY COMMITTEE May 2017	BENCHMARK S&P 500 May 2017
Energy	5.25%	6.02%
Materials	2.30%	2.80%
Industrials	12.00%	10.13%
Consumer Discretionary	13.00%	12.44%
Consumer Staples	8.50%	9.39%
Health Care	14.50%	13.83%
Financials	13.00%	13.82%
Information Technology	26.00%	23.23%
Telecommunication Services	1.50%	2.20%
Utilities	2.50%	3.25%
Real Estate	1.45%	2.89%

Source: RBC GAM

S&P 500 EQUILIBRIUM
Normalized earnings and valuations



rotation into growth and defensive issues, and out of value, was driven more by fading expectations for the Trump administration's agenda than anticipation that the economy might experience a significant slowdown.

Since Trump's election in November 2016, the S&P 500 has gained 13%. While the move higher was driven by anticipation of pro-growth policies, strong fundamentals have helped offset concern that Trump and Congressional Republicans will struggle to pass those policies in the near term. Surveys of U.S. economic activity have stabilized near a six-year high and new-order and inventory components indicate that production should continue improving for at least several months. The housing market is improving at a measured pace,

with prices rising at a mid-single-digit rate year over year and total sales rising at a low-single-digit rate. The housing cycle appears intact, but rising rates and higher prices will act as headwinds unless income growth accelerates.

The pace of U.S. job growth is slowing, as is typical later in the business cycle, but the economy has still created an average of 240,000 new jobs per month this year. The unemployment rate rests at 4.3%, a 16-year low, and there is some upward pressure on wage growth. Wage growth is currently about 2.5%-3.0% but could top 4% if economic activity continues to improve, perhaps leading to inflation becoming a problem. For now, our estimation is that the U.S. consumer remains in good health, as balance sheets are healthy, debt levels are down and home equity is up strongly since the financial crisis. An analysis shows that 30% of the average consumer's debt is allocated among student loans, auto loans and credit cards, with mortgage debt making up the remaining 70%. While delinquency rates are picking up in auto and credit-card loans, there are no obvious signs of trouble in mortgages. In addition, consumer incomes are increasing faster than their borrowings, and most debt is both long-term and fixed-rate.

Corporate fundamentals are also supporting the market. After three years of essentially flat earnings, we expect the companies in the S&P 500 to report 10% earnings growth in aggregate this year. The drop in the oil price from mid-2014 until early 2016, plus the 20% rally in the trade-weighted U.S. dollar over a similar period, depressed earnings in the Energy sector and among multinationals with significant revenue from currencies other than the dollar. The negative effects of the U.S. dollar and oil prices started to wane in last year's third quarter. In the current quarter, profits could get a boost from an increase in corporate spending on technology and equipment, which have a disproportionate impact on the S&P 500 earnings pool given the size of the likely beneficiaries (Information Technology and Industrials sectors) and their leverage to rising revenues. In addition, slightly higher interest rates and a steeper yield curve would help the Financials sector.

Looking forward, our base case is that the economy will continue to expand slowly and that interest rates will rise gradually over the next year. Currently, the S&P 500 trades at roughly 17.7 times consensus earnings estimates for the next 12 months. While this is relatively expensive, we note that market valuations often rise in periods when economic growth is modest and sectors like Information Technology and Consumer Discretionary lead the way.

Were economic growth to accelerate, interest rates would rise and the yield curve would steepen. In this environment, the Financials and other more cheaply valued sectors would likely assume leadership and cause market valuations to shrink. The likely catalyst for such a market move would be progress by the Trump administration and Congress on economic policy. We estimate that the implementation of Trump's agenda would increase S&P earnings by 5%-10% in 2018. At the moment, however, prospects for tax reform and infrastructure spending seem remote, and so we are not factoring these outcomes into our base case. We do, however, expect significant regulatory changes and cash repatriation to provide some support for growth in 2018.

In our bearish scenario, a number of things would conspire to slow the economy. These could include rising mortgage rates; higher gasoline prices; an unexpectedly strong appreciation in the U.S. dollar; a greater-than-expected slowdown in Chinese economic growth; and implementation of any U.S. protectionist trade policies. In addition, investors should expect at least a 10% correction in the stock market if it appears that tax reform is going to be delayed or watered down.

In a bullish scenario, we would see an increase in bank lending to small business, increased capital investment by corporations and a bump up in spending on defense and infrastructure. In this scenario, corporate earnings and stocks would likely go much higher. For now, we expect the stock market to grind higher, while we remain vigilant for signs that the business cycle is coming to an end.

REGIONAL OUTLOOK – CANADA

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Portfolio Manager
RBC Global Asset Management Inc.

Sarah Neilson, CFA
Portfolio Manager
RBC Global Asset Management Inc.

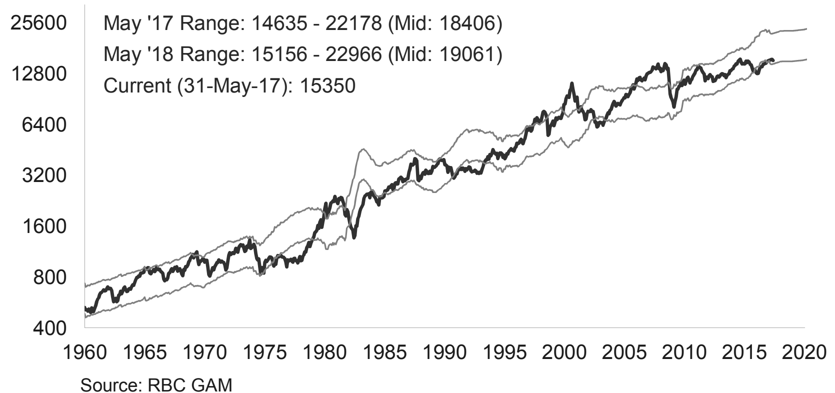
CANADA RECOMMENDED SECTOR WEIGHTS

	RBC GAM INVESTMENT STRATEGY COMMITTEE May 2017	BENCHMARK S&P/TSX COMPOSITE May 2017
Energy	20.00%	20.77%
Materials	11.75%	11.86%
Industrials	11.00%	9.55%
Consumer Discretionary	6.00%	5.40%
Consumer Staples	4.00%	3.94%
Health Care	0.00%	0.60%
Financials	33.00%	33.55%
Information Technology	4.50%	3.05%
Telecommunication Services	4.50%	5.04%
Utilities	2.75%	3.25%
Real Estate	2.50%	2.97%

Source: RBC GAM

The S&P/TSX Composite Index pared gains after hitting an all-time high in February of this year. Between January 1 and May 31 of 2017, the S&P/TSX delivered a 1.5% total return, lagging the S&P 500 by 720 basis points and the MSCI World by 900 basis points. This underperformance was primarily a result of weakness in the Financials and Energy sectors, which together represent just over 50% of Canada's benchmark stock index. The Canadian dollar has been largely unchanged versus the U.S. dollar at $0.74 since the beginning of the year, mainly due to a better-than-expected Canadian economy. The Bank of Canada recently left the overnight rate unchanged, but also added a hawkish undertone with its belief that the economy will return to full potential sometime in the first half of 2018.

S&P/TSX COMPOSITE EQUILIBRIUM
Normalized earnings and valuations



Source: RBC GAM

Stocks in the Financials sector took a pause after a strong advance earlier in the year. Canadian banks lost 4.7% in the three-month period amid the unwind of the "Trump trade" and rising sovereign-bond prices. The yield on the Canadian 10-year bond stands near 1.40%, down from its February high of 1.87%. Gold stocks rose 7.0% through May but were flat during the latest three-month period. The performance of the Energy sector had a meaningful negative impact on the S&P/TSX, as it is was down 10.8% through May.

Global economic growth is expected to trend modestly higher this year. Our forecast for U.S. growth in 2017 now sits at 2.0% and has increased to 2.0% for Canada as well. Inflation expectations for the U.S. have softened somewhat since the U.S. election as investors question Trump's ability to execute on his pro-growth agenda. The Canadian economy has had a strong start to 2017, but the pace of growth may be difficult to maintain. We expect that Canada's path to higher interest rates will be longer and slower than in the U.S., with the Canadian

economy's reliance on housing, consumer spending and energy projects remaining key points of discussion. We are also monitoring for the potential impact of any U.S. protectionist measures on Canadian trade. Negotiations for a reworked North American Free Trade Agreement could begin this summer.

For the S&P/TSX, 2017 earnings estimates are now about $918, and for 2018 at about $1,044. These forecasts are a considerable uptick over 2016 and reflect returns on equity consistent with longer-term averages. The earnings generated in the Energy sector account for almost half of the 2017 profit-growth projection for the S&P/TSX and almost a third of the 2018 forecast increase. The recovery in oil prices from their severe collapse last year drives the earnings gains and assumes the price of oil makes its way from about US$45 now toward US$60 per barrel. Outside the commodity sectors, expectations for the remainder of the earnings pool are healthy. Valuations for the S&P/TSX are moderately lower than the S&P 500, a discount that seems justified given the energy-price forecast and the impact of financial earnings on the overall profit pool.

Forward price-to-earnings multiples for the banks have fallen to more attractive levels after trading at pre-crisis highs following the U.S. election. In the latest quarter, all large Canadian banks delivered double-digit earnings growth driven by healthy loan growth, stable net-interest margins and declining provisions for credit losses. While valuations are tough to predict, the banks continue to offer investors attractive dividend yields and dividend growth in line with earnings, and they remain solid total-return investments. The focus will now be on the state of the Canadian consumer and provisions for credit losses, which are relatively low. The performance of the banks' capital-markets, wealth-management divisions and non-domestic businesses will likely be the key differentiators of performance.

Home Capital Group, the leading Canadian subprime-mortgage lender, created investor angst starting in April when creditors began making significant withdrawals from the company's high-interest savings accounts. To quell insolvency concerns, Home Capital's management resorted to borrowing at rates that were much higher than would have been expected. While Home Capital's asset quality remains strong, funding concerns and the likelihood of a significant class-action lawsuit have kept potential acquirers at bay. We believe the any contagion posed by Home Capital to the financial system is a remote risk.

Shares of life-insurance companies fell in the three-month period, mainly because of weaker-than-expected first-quarter reports. Industry earnings were driven by company-specific issues and Manulife Financial stood out as a relative winner. The outlook for the insurers remains positive as they tend to perform well during periods of monetary tightening. Valuations in the Telecommunication Services, Utilities and Real Estate sectors are near the top of their historical trading ranges, as falling 10-year government-bond yields supported the recent outperformance of these interest-sensitive sectors. The Industrials sector has been the strongest in the S&P/TSX through the five months ended May 31. This has been driven mainly by the railroads, which are benefiting from the solid economic growth and a pick-up in activity amid the Energy-sector recovery. However, Canadian railroads currently trade at elevated multiples.

Oil prices remain difficult to forecast in the short run, but remain below our estimate of marginal cost. Despite OPEC's move to cut production late last year and more recently the extension of this plan through early 2018, global inventory levels remain above long-term averages, and this situation continues to weigh on prices. The rapid recovery of U.S. shale production and its impact on global supply is being closely monitored. Should oil prices remain below US$50 a barrel, the balance sheets of domestic energy producers will once again be in focus given reductions in cash flow. We continue to believe that large companies with long-life reserves and strong balance sheets are set to deliver attractive levels of free cash as crude prices return to the marginal cost of production.

REGIONAL OUTLOOK – EUROPE

Dominic Wallington
Head, European Equities & Senior Portfolio Manager,
RBC Global Asset Management (UK) Limited

We continue to witness synchronized global growth, with the Chinese economy exhibiting unexpected resilience and the U.S. continuing to remain firm. This development creates a benign backdrop for continued economic recovery in much of Europe and is beginning to feed through to an uptick in corporate earnings for the first time in four years.

Equally important to understand is that Europe is at a much earlier stage of its economic recovery than the U.S. and could therefore have longer to go before it is likely to see another downturn. The damage to European corporate earnings from the financial crisis was more extensive than in the U.S. and earnings per share for listed companies are still 25% below the levels seen at the 2007 peak.

The risk to this positive economic environment remains the political situation in Europe. Markets tend only to react meaningfully to political risk when it presages a fundamental change in the business environment. Brexit and the election of Donald Trump in the U.S. have not led to the sort of permanent market damage that many investors had feared, even though both represented substantial events. We believe, however, that the election of a Eurosceptic government in the heart of Continental Europe would represent a disruptive event and we are therefore watching events very carefully.

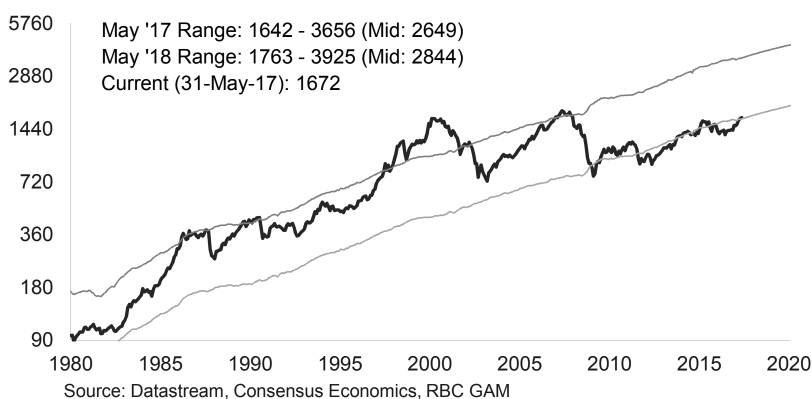
Political risk has been somewhat offset by Emmanuel Macron's election last month as France's president. Macron is highly Eurocentric and in many respects represents the status quo. The day-to-day volatility of French politics should now become much less important to stock markets because it will not interrupt the ability of French companies to allocate capital as they wish and will also not create an environment where corporate profitability is likely to be at risk. In this scenario, even if domestic politics remain problematic we can

EUROPE RECOMMENDED SECTOR WEIGHTS

	RBC GAM INVESTMENT STRATEGY COMMITTEE May 2017	BENCHMARK MSCI EUROPE May 2017
Energy	5.50%	6.75%
Materials	8.50%	7.89%
Industrials	14.75%	13.24%
Consumer Discretionary	12.00%	10.76%
Consumer Staples	15.00%	14.27%
Health Care	14.50%	13.12%
Financials	18.00%	20.35%
Information Technology	5.50%	4.50%
Telecommunication Services	3.00%	4.16%
Utilities	2.50%	3.60%
Real Estate	0.75%	1.36%

Source: RBC GAM

EUROZONE DATASTREAM INDEX EQUILIBRIUM
Normalized earnings and valuations



Source: Datastream, Consensus Economics, RBC GAM

go back to looking at the economic progress of the companies rather than the newspaper headlines on political machinations.

In this environment, the medium-term backdrop remains fairly constructive, even if we may be nearing some seasonal weakness. Angela Merkel appears to have solidified her position ahead of German elections later this year, and so the next significant political hurdle for Europe will be Italian elections slated for sometime in 2018. While the Eurosceptic party, Five Star, is leading in the polls, political developments are in a state of flux and the party itself in some chaos. Whatever the longer-term political developments in Europe, we believe our strategy of investing in the highest-quality, internationally oriented companies is the best approach to dealing with any given macroeconomic environment.

Our areas of focus in the Consumer Discretionary sector have been media, gaming and consumer durables. We remain especially committed to media companies that have reduced their capital intensity and broadened their exposure through the internet. In the Consumer Staples sector, we remain focused on beverages, food ingredients and household goods because these areas offer the best mix of growth and valuation. We remain underweight in food manufacturing. Most of the exposure to this sector is global in nature and capitalizes on the growing middle class in emerging markets.

We are a little more comfortable with the Energy sector, as concerns about increased capital expenditures and weak production growth have subsided somewhat. Valuations in the sector are at almost unprecedentedly low levels, both in absolute and relative terms, but are not enough to completely offset the fundamental backdrop of lower energy prices. Dividend yields are high, but for many international oil companies high levels of capital expenditure mean that they are only just covered by cash flow.

A tighter regulatory backdrop means that banks are unlikely to return to levels of profitability seen before the financial crisis, and many financial institutions will struggle to generate returns above their cost of equity. Within the Financials sector, our preference remains for banks with high returns on equity and strong balance sheets. This results in a bias towards the Nordic region and limited exposure to the Eurozone. Our exposure to insurance remains in multi-line companies, mainly in Scandinavia. We also see great appeal in asset managers given their high-return, capital-light business models.

Health Care was the first defensive sector to begin underperforming a year ago, and it also looks likely to be the first to stabilize. The sector's strong balance sheets, robust cash flows, low earnings volatility and focus on capital returns provide the credentials we look for. Our exposure is predominately focused on a number of large-cap pharmaceuticals companies whose valuations appear unjustifiably low or whose long-term growth prospects are under-appreciated.

Our preference within the Industrials sector has been for secure growth and returns that are high and stable, or companies with improving operations. Information Technology is still one of our preferred sectors in Europe. We view software companies as benefiting from late-cycle increases in corporate spending over the coming years. After underperforming throughout the early 2000s, expectations remain relatively low and management teams are demonstrating a higher degree of capital discipline. In the Materials sector, our long-term preference is in the specialty-chemicals producers and in the niche areas of enzymes and flavours and fragrances, where we see high barriers to entry and good growth and returns.

We are less optimistic about the Utilities sector, which trades at a valuation discount to the overall market and has the highest dividend yield. However, any valuation support is undermined by weak fundamentals.

REGIONAL OUTLOOK – ASIA

Mayur Nallamala
Head & Senior Portfolio Manager
RBC Investment Management (Asia) Limited

Asian markets

Asian stock indexes continued to perform strongly in the latest three-month period, outperforming other major global markets. Asian equities have benefited from a positive economic and political backdrop, with Indonesia receiving a credit-ratings upgrade from Standard & Poor's, South Korea electing a new president and China easing monetary conditions. Japanese equities exhibited more volatility than many other markets over the past three months, reflecting fluctuations in the yen.

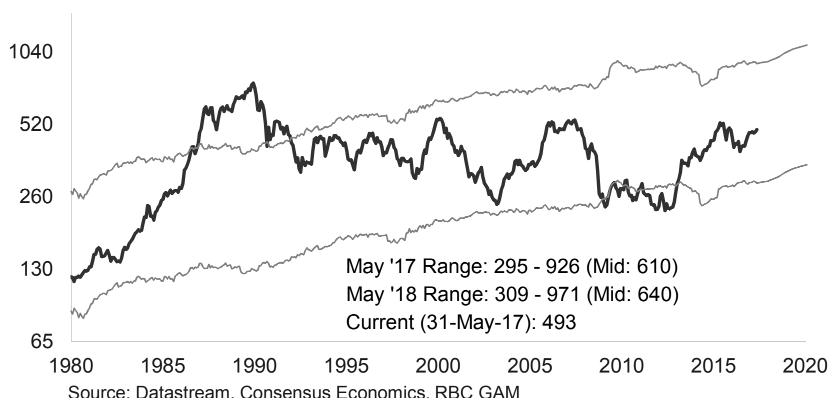
Macroeconomic conditions are softening somewhat, and so we are becoming slightly more cautious about the outlook for equity markets. Economic statistics may disappoint amid weakening commodity prices and regional geopolitical risks led by North Korea's periodic missile tests. Across the region, the Information Technology and consumer sectors have outperformed, while Materials and Telecommunication Services have underperformed.

ASIA RECOMMENDED SECTOR WEIGHTS

	RBC GAM INVESTMENT STRATEGY COMMITTEE May 2017	BENCHMARK MSCI PACIFIC May 2017
Energy	2.00%	2.94%
Materials	7.00%	6.40%
Industrials	13.50%	12.39%
Consumer Discretionary	14.00%	12.98%
Consumer Staples	6.00%	6.43%
Health Care	5.00%	4.78%
Financials	21.00%	21.45%
Information Technology	21.00%	19.23%
Telecommunication Services	3.50%	4.98%
Utilities	2.50%	2.76%
Real Estate	4.50%	5.65%

Source: RBC GAM

JAPAN DATASTREAM INDEX EQUILIBRIUM
Normalized earnings and valuations



Source: Datastream, Consensus Economics, RBC GAM

Japan

Japanese markets were choppy during the latest period. The country's stock market is tied largely to changes in the value of the yen, which tends to rise when geopolitical tensions escalate as they did on the Korean peninsula. Economic data in Japan has been reasonably encouraging, offsetting some of the negative impact of the yen due to the safe-haven appreciation.

We have raised our 2017 GDP forecasts for Japan to 1.25% from 0.75%, given an improvement in private consumption and an increase in capital expenditures.

Japan's economy has expanded for five consecutive quarters, the first such sequential performance in more than a decade. Abenomics, with its accommodative fiscal and monetary policies, deserves much of the credit for Japan's improving economic position. While inflation has continued to undershoot the Bank of Japan's (BOJ) 2% target,

wage growth and employment are picking up. The BOJ is expected to continue easing monetary policy, but the scale of the easing may decline. As a result, the yen and equity markets may be more susceptible to geopolitical forces than has been the case in the recent past.

Abe's political position remains strong and he continues to push forward with longer-term structural reforms. Most analysts expect BOJ Governor Kuroda to be reappointed when his term ends in April 2018 to ensure that the central bank extends its efforts to keep longer-term interest rates exceptionally low while scaling back purchases of Japanese government bonds (yield-curve control). Abe's fiscal-stimulus packages continue to focus on infrastructure, wage growth and consumption, a combination that should help stimulate growth over the next two years. A gradual improvement in corporate governance should also lead to better investor returns in the years ahead.

Asia Pacific ex-Japan

Asian stock markets got their boost from a rebound in exports and the uptick in China's economic growth. However, potential risks for Asia include the possibility of a more protectionist U.S. on trade, faster-than-expected U.S. interest-rate hikes and higher geopolitical risks arising from North Korean provocations. Within Asia, China, South Korea and Indonesia outperformed over the past three months, while Australia and Thailand underperformed.

In China, the government appears to have achieved a better balance of economic growth. Larger-scale economic reform will more likely be pushed back to 2018, as the Communist Party's old guard will be replaced this November. Economic restructuring could be negative for growth at first, so growth targets will need to be lowered if and when significant reforms are implemented. Periodic concerns about the value of China's currency and currency outflows are offset by ample foreign-exchange reserves and the government's willingness to use capital controls.

China's debt-to-GDP ratio of over 270% remains the key reason why Moody's downgraded China's debt rating in mid-May. Chinese regulators have been tightening monetary conditions as well as their control over shadow banking, leading to periodic liquidity injections from the People's Bank of China. China continues to pursue "one belt, one road," a program aimed at streamlining trade with other countries in Asia and Europe, and the announcement of a technology-oriented economic-development zone called Xiong'an boosted shares of some property companies.

South Korean consumer sentiment rose to its highest level in three years after the election last month of President Moon. Investors are hoping for better corporate governance under the new president, who named a fair-trade commissioner to promote economic competition. Information Technology companies have since outperformed.

Standard & Poor's upgraded Indonesia's sovereign-credit rating in mid-May to investment grade, reflecting the country's improved fiscal position aided by a tax-amnesty program. The Jokowi administration continues to implement reforms and enjoys a high approval rating. He is backed by 70% of the seats in the parliament.

Australian equities have been relatively weak, dragged down by declines in the Financials sector, where banks have been hit hard by the introduction of a tax on certain liabilities. Commodity stocks have also fallen given the slide in prices for iron ore and crude oil. Australia remains unusually reliant on the commodity and Financials sectors, which account for more than half of the country's benchmark stock index, and efforts are underway to rebalance the economy towards non-mining areas such as housing construction, services and household consumption.

REGIONAL OUTLOOK – EMERGING MARKETS

Guido Giammattei
Portfolio Manager,
Emerging Market Equities
RBC Global Asset Management (UK) Limited

Emerging-market equities extended their recovery, surging 7.9% in the three months ended May 31, 2017. The gain in emerging-market stocks so far this year has been 16% – six percentage points more than in developed markets. Returns were driven primarily by macroeconomic and fundamental improvements that included a fragile but sustained global economic recovery, higher earnings and strong inflows. The U.S. Federal Reserve's inclination to move methodically on monetary policy has also helped, as has the lingering impact of Donald Trump's election as U.S. president, which many investors believe has boosted the odds of stronger global growth.

The macroeconomic news has been encouraging for emerging markets. In China, the country's purchasing managers' index rose to a five-year high in March and domestic consumption remains strong. In India, the economic impact of the ban on large banknotes was relatively modest, and the introduction of a growth-friendly budget has pushed up equities. Rate cuts and sustained momentum on reform in Brazil point to a fairly positive environment for that country, although political events recently took a turn for the worse. From a sector perspective, the Information Technology, Consumer Discretionary and Financials sectors are performing well so far this year. The Energy sector has lagged, and so have Utilities and Real Estate. Emerging-market currencies have risen 4.4% through May in aggregate, led by the Mexican peso, the Russian ruble and the South Korean won.

EMERGING MARKET DATASTREAM INDEX EQUILIBRIUM
Normalized earnings and valuations

Source: Datastream, RBC GAM

A key difference between this year's market and 2016 is that no investment style has been dominant, and the reflation trade that pushed investors into value and deep-value equities last year has shown signs of slowing in 2017, if not reversing outright. As crude-oil prices have remained range-bound or lower, inflation expectations were tempered and investor sentiment shifted to cyclical sectors such as Information Technology and Consumer Discretionary. Furthermore, as markets stabilized, investors have been able to focus on fundamental data, which meshes with our strategy of emphasizing bottom-up analysis to identify quality equities.

Our baseline view is that the recovery in emerging-market economies continues, with macroeconomic factors and emerging-market fundamentals likely to determine absolute and relative performance in the coming months. Over the past 20 years, the factors that have had the greatest influence on the relative performance of emerging-market equities have been: the relative growth of emerging-market economies versus developed markets; changes in emerging-market credit performance; and relative returns on equity.

Commodity prices are also important, but their importance has been coming down over time. Relative valuations are relevant only at the margin, while fluctuations in the U.S. dollar – contrary to the belief of many investors – is not a significant driver of emerging-markets' relative performance.

As we write, all the stars seem favourably aligned for emerging-market equities in terms of the aforementioned variables.

The first driver – faster relative growth in emerging markets – has historically been the key reason for investing in emerging markets and has driven long-term performance. The emerging-market/developed-market growth differential bottomed in 2015, and in 2016 there was a marked improvement. Coincidentally, 2016 is also the year in which emerging-market equities bottomed on a relative basis and then started to outperform developed-market equities.

Looking ahead, the change in the growth differential between emerging markets and developed markets is likely to continue to support emerging-market equities. Economic momentum has continued into 2017, and emerging-market purchasing managers' indexes have risen for six consecutive months to reach their highest level in four years.

Several models suggest that emerging-market credit spreads are also a significant driver of emerging markets' relative equity outperformance. As the creditworthiness of a sovereign improves (Brazil in 2016, for example, or Asia in the early 2000s), it typically leads to higher valuations for equities, a decline in the weighted average cost of capital and currency appreciation. While emerging-market credit spreads have already contracted by 50 basis points in aggregate so far this year, building on a 100-basis-point narrowing in 2016, they still don't appear stretched: yields on countries in the JPMorgan Emerging Market Bond Index are still more than double what they were relative to developed markets before the financial crisis.

Perhaps the most important and favourable change in recent years is that the profitability of emerging-market companies, as measured by returns on equity, appears to have found a bottom in 2016, and has after many years of decline, overtaken the developed world. Earnings-momentum measures are now rebounding strongly across the world, led by emerging markets.

Consensus forecasts for emerging-market profits have risen over the past three months at a pace not seen in seven years. As a result, earnings growth is projected to bounce back in emerging markets in 2017 following five lacklustre years. Analyst surveys suggest emerging-market earnings could improve by as much as 23% this year, in contrast to zero growth in 2015 and a 2% contraction in 2016. The recovery in returns on equity and profits is essential to the continuation of the positive momentum for emerging-market equities. The valuation case for emerging-market equities remains attractive even after the recent strong performance. While no longer as cheap as they were, emerging-market equities are still attractive relative to developed-marked stocks based on price-to-book value and returns on equity.

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Daniel E. Chornous, CFA

Chief Investment Officer
RBC Global Asset Management

Chair, RBC GAM Investment Strategy Committee

Dan Chornous is Chief Investment Officer of RBC Global Asset Management Inc., which has total assets under management of $402 billion. Mr. Chornous is responsible for the overall direction of investment policy and fund management. In addition, he chairs the RBC Investment Strategy Committee, the group responsible for global asset-mix recommendations and global-fixed income and equity portfolio construction for use in RBC Wealth Management's key client groups including retail mutual funds, International Wealth Management, RBC Dominion Securities Inc. and RBC Phillips, Hager & North Investment Counsel Inc. He also serves on the Board of Directors of the Canadian Coalition for Good Governance and is Chair of its Public Policy Committee. Prior to joining RBC Asset Management in November 2002, Mr. Chornous was Managing Director, Capital Markets Research and Chief Investment Strategist at RBC Capital Markets. In that role, he was responsible for developing the firm's outlook for global and domestic economies and capital markets as well as managing the firm's global economics, technical and quantitative research teams.

Stephen Burke, PhD, CFA

Vice President and Portfolio Manager
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Stephen is a fixed-income portfolio manager and Head of the Quantitative Research Group, the internal team that develops quantitative research solutions for investment decision-making throughout the firm. He is also a member of the PH&N IM Asset Mix Committee. Stephen joined Phillips, Hager & North Investment Management in 2002. The first six years of his career were spent at an investment-counselling firm where he quickly rose to become a partner and fixed-income portfolio manager. He then took two years away from the industry to begin his Ph.D. in Finance and completed it over another three years while serving as a fixed-income portfolio manager for a mutual-fund company. Stephen became a CFA charterholder in 1994.

Dagmara Fijalkowski, MBA, CFA

Head, Global Fixed Income & Currencies
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As Head of Global Fixed Income and Currencies, Dagmara leads a 25-person team in Toronto and London with about $50 billion in assets. In her duties as a portfolio manager, Dagmara oversees several bond funds and manages foreign-exchange hedging and currency-management programs. Dagmara chairs the Fixed Income Strategy Committee. She is also a member of the Investment Policy Committee, which determines asset mixes for balanced products, and the RBC Investment Strategy Committee. In 2016, she was appointed to the RBC GAM Executive Committee. Dagmara, who began her investment career in 1994, holds an MBA from the Richard Ivey School of Business in Canada and a Master's degree in economics from the University of Lodz in Poland. Dagmara is a CFA charterholder.

Stuart Kedwell, CFA

Senior Vice President and
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Stu began his career with RBC Dominion Securities in the firm's Generalist program and completed rotations in the Fixed Income, Equity Research, Corporate Finance and Private Client divisions. Following this program, he joined the RBC Investments Portfolio Advisory Group and was a member of the RBC DS Strategy and Stock Selection committees. He later joined RBC Global Asset Management as a senior portfolio manager and now manages the RBC Canadian Dividend Fund, RBC North American Value Fund and a number of other mandates. He is co-head of RBC Global Asset Management's Canadian Equity Team.

Eric Lascelles

Chief Economist
RBC Global Asset Management

Eric is the Chief Economist for RBC Global Asset Management Inc. (RBC GAM) and is responsible for maintaining the firm's global economic forecast and generating macroeconomic research. He is also a member of the RBC GAM Investment Strategy Committee, the group responsible for the firm's global asset-mix recommendations. Eric is a frequent media commentator and makes regular presentations both within and outside RBC GAM. Prior to joining RBC GAM in early 2011, Eric spent six years at a large Canadian securities firm, the last four as the Chief Economics and Rates Strategist. His previous experience includes positions as economist at a large Canadian bank and research economist for a federal government agency.

Hanif Mamdani

Head of Alternative Investments
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Hanif Mamdani is Head of both Corporate Bond Investments and Alternative Investments. He is responsible for the portfolio strategy and trading execution of all investment-grade and high-yield corporate bonds. Hanif is Lead Manager of the PH&N High Yield Bond Fund and the PH&N Absolute Return Fund (a multi-strategy hedge fund). He is also a member of the Asset Mix Committee. Prior to joining the firm in 1998, he spent 10 years in New York with two global investment banks working in a variety of roles in Corporate Finance, Capital Markets and Proprietary Trading. Hanif holds a master's degree from Harvard University and a bachelor's degree from the California Institute of Technology (Caltech).

Martin Paleczny, CFA

Vice President and
Senior Portfolio Manager
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Martin Paleczny, who has been in the investment industry since 1994, began his career at Royal Bank Investment Management, where he developed an expertise in derivatives management and created a policy and process for the products. He also specializes in technical analysis and uses this background to implement derivatives and hedging strategies for equity, fixed-income, currency and commodity-related funds. Since becoming a portfolio manager, Martin has focused on global allocation strategies for the full range of assets, with an emphasis on using futures, forwards and options. He serves as advisor for technical analysis to the RBC GAM Investment Strategy Committee.

Sarah Riopelle, CFA

Vice President and
Senior Portfolio Manager
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Since 2009, Sarah has managed the entire suite of RBC Portfolio Solutions, including the RBC Select Portfolios, RBC Select Choices Portfolios, RBC Target Education Funds and RBC Managed Payout Solutions. Sarah is a member of the RBC GAM Investment Strategy Committee, which sets global strategy for the firm, and the RBC GAM Investment Policy Committee, which is responsible for the investment strategy and tactical asset allocation for RBC Funds' balanced products and portfolio solutions. In addition to her fund management role, she works closely with the firm's Chief Investment Officer on a variety of projects, as well as co-manages the Global Equity Analyst team.

William E. (Bill) Tilford

Head, Quantitative Investments
RBC Global Asset Management

Bill is Head, Quantitative Investments, at RBC Global Asset Management and is responsible for expanding the firm's quantitative-investment capabilities. Prior to joining RBC GAM in 2011, Bill was Vice President and Head of Global Corporate Securities at a federal Crown corporation and a member of its investment committee. His responsibilities included security-selection programs in global equities and corporate debt that integrated fundamental and quantitative disciplines, as well as management of one of the world's largest market neutral/overlay portfolios. Previously, Bill spent 12 years with a large Canadian asset manager, where he was the partner who helped build a quantitative-investment team that ran core, style-tilted and alternative Canadian / U.S. funds. Bill has been in the investment industry since 1986.

Brad Willock, CFA

Vice President and
Senior Portfolio Manager
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Brad Willock, who joins the RBC Investment Strategy Committee this quarter, came to RBC Financial Group in May 1996 after receiving a Bachelor of Commerce degree with distinction from the University of Calgary. Prior to that, he earned a Bachelor of Science degree from the University of British Columbia and represented Canada at the 1992 Barcelona Summer Olympics in volleyball. Brad joined RBC Global Asset Management Inc. in July 2002 and is a Senior Portfolio Manager and CFA charterholder. He manages the RBC U.S. Dividend Fund, the equity portion of the RBC $U.S. Income Fund as well as the U.S. equity sleeve of the RBC Balanced Growth & Income Fund.

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