RBC WEALTH MANAGEMENT

GLOBAL INSIGHT

WEEKLY

DECEMBER 18, 2015

A CLOSER LOOK

Zero Percent Takes a Hike

Kelly Bogdanov – San Francisco

The rate hike is here … now what? The Fed has given the economy a vote of confidence. But we think the real work is just starting for the Fed as it dips its toes in the rate hike waters.

With its first rate hike in almost 10 years the Federal Reserve finally managed to deliver to markets roughly what they expected and begin rebuilding confidence with investors following a string of mixed messages and false starts this year. Officials moved off of the emergency 0% level established during the financial crisis by raising its target rate corridor by 25 basis points to 0.25%–0.50%.

Equities initially rallied across regions, but sold off in subsequent sessions as crude oil drifted lower and liquidity began to thin due to the approaching holidays. Safe-haven government bond yields were mixed in major markets, but rose in the U.S., especially at the short end of the Treasury yield curve. The U.S. Dollar Index increased 1.2% for the week, but failed to reach a new high.

Not Your Father's Tightening Cycle

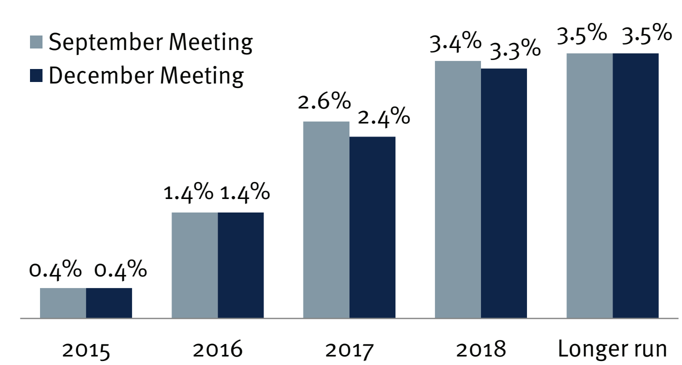
Investors immediately shifted attention to the pace of the rate hike cycle, and that's where opinions differ.

Fed officials still forecast four additional 25 basis point rate hikes in 2016, one per quarter, although they ratcheted down expectations slightly for 2017 and 2018 (see chart). Keep in mind, language in the Fed's formal statement and press conference seemed more dovish than these forecasts.

Various market-based measures assume three or four rate hikes next year, and most rates strategists and economists at investment firms are within this zone as well.

2017 and 2018 Forecasts Changed Only Slightly

Federal Reserve's Median Fed Funds Rate Forecasts



Source - RBC Wealth Management, RBC Capital Markets US Economics, Federal Reserve

MARKET PULSE

The *Global Insight Weekly* will not be published during the holidays. The next edition will be available January 8 in North America and January 11 in Europe and Asia.

RBC Wealth Management's fixed income strategies team, however, believes the Fed may end up delivering only two 25 basis point rate hikes in 2016.

Inflation could be a key factor. If the Fed's favorite inflation measure (core PCE) fails to rise much beyond its current 1.3% level, rate hikes could move at a snail's pace compared to the "gradual" pace the Fed is forecasting. The Fed downgraded its assessment for inflation in its formal statement, and no longer seems confident core inflation will reach its 2% goal over the medium term.

Our strategies team also doubts the peak or terminal rate at the end of this tightening cycle will reach 3.5% as the Fed is currently forecasting. While that terminal level would be much lower than previous rate hike cycles (5.25% in 2006), it could conceivably end up being as low as 2% this go around, in their view. Some market-based measures are pegging it at 2.5%.

There is plenty of scope for the debate about the pace of tightening to be just as lively as the debate about the timing of the first rate hike. This could create volatility in bonds, stocks, and currencies, along with opportunities.

Finding the Way

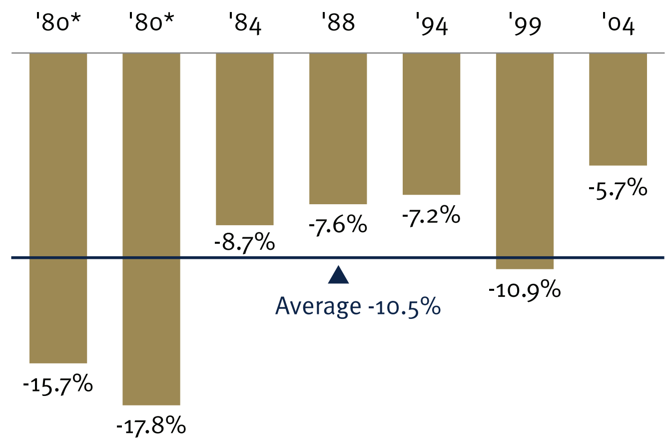
The U.S. equity market usually maneuvers around the early stages of a Fed tightening cycle, but there can be pullbacks.

In the seven tightening cycles since 1980, the S&P 500 corrected an average of 10.5% at some point during the 12-month period following the first rate hike (see top chart). Sometimes the corrections were caused by Fed-related stress, but economic or external factors often played a role too. The moves, however, were usually short-lived. Six of the seven corrections lasted 58 days, on average. And the market often more than made up its lost ground with a 19.7% average gain 12 months after it reached bottom (see lower chart).

Even if the new Fed rate hike cycle contributes to a U.S. equity pullback in the next 12 months—which would be a normal reaction—we continue to believe the secular (long term) bull market has further to run and will reward investors with worthwhile returns in 2016.

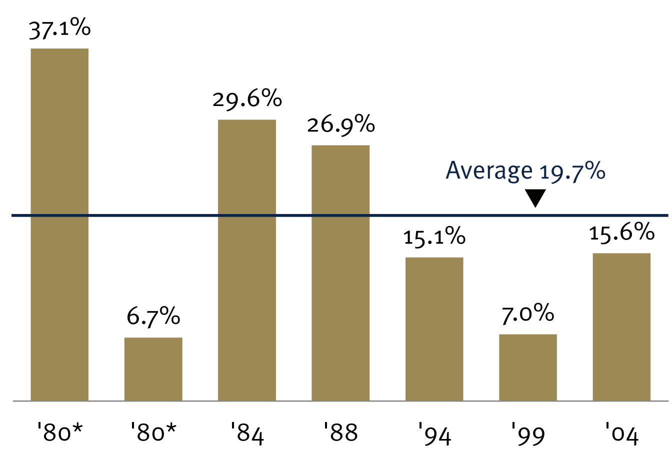
The U.S. economic foundation, while imperfect, is sturdy enough to deliver moderate GDP growth. The most important segments of the economy (services, consumer) should continue to lead next year. The market's 15.7x forward valuation is reasonable, in our view, and most sectors seem well positioned to grow earnings. Additionally, the market typically rises in presidential election years, regardless of which party wins or whether the incumbent party wins another term. Also, flat years (+/- 3% returns), like 2015 is shaping up to be, are typically followed by gains. After the 10 flat years since WWII, the S&P 500 rose 13% for the year, on average.

S&P 500 Corrections Within 12 Months *After* the First Rate Hike



* Two distinct tightening cycles in 1980 separated by a rate cut cycle in between (Volcker era), occurred amid a double-dip recession.
Source - RBC Wealth Management, Bloomberg; data measures Federal Reserve rate hike cycles since 1980

S&P 500 Performance 12 Months Following the Correction Low



* Two distinct tightening cycles in 1980 separated by a rate cut cycle in between (Volcker era), occurred amid a double-dip recession.
Source - RBC Wealth Management, Bloomberg; years represent the first rate hike of a cycle, rebounds are 12 months after the correction low that followed the first rate hike

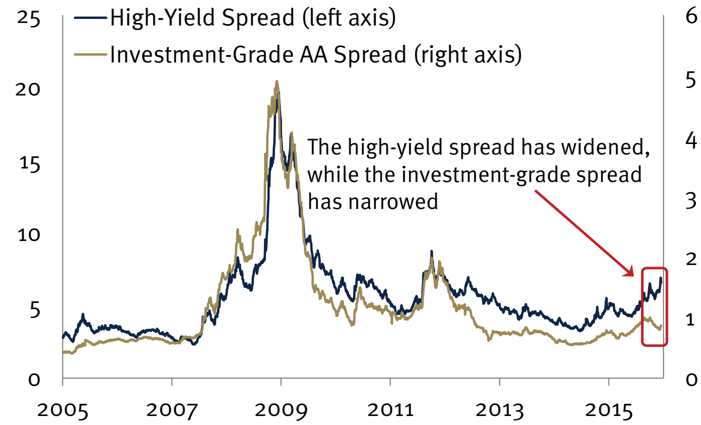
UNITED STATES

Kelly Bogdanov – San Francisco

- **The Fed's rate hike and messaging struck the right tune for U.S. equities**. All sectors traded higher the day of the announcement except energy. Industries that benefit from a higher Fed Funds rate, such as banks, rose almost 2%. Furthermore, areas of the market normally hurt by rate hikes (e.g., utilities and REITs) rallied by similar magnitudes because the Fed affirmed the rate hike cycle should unfold gradually.
- **However, the persistent crude oil correction continued to weigh on sentiment and held back the equity market**. While the S&P 500 had been up 3% for the week following the Fed meeting, it closed down 0.3%. As WTI crude oil declined further, reaching $34.73/barrel late Friday, it seemed like **forced selling in the energy sector prompted profit-taking in the broader market** among institutional investors that needed to raise cash to cover margin positions or redemptions. Crude oil dropped again as **U.S. supplies surged to the highest level at this time of year since 1930**, according to the Energy Information Administration. The OPEC side of the supply equation still isn't helping matters. Following the cartel's recent meeting, the market perceives **Saudi Arabia is determined to keep production high** in order to force weaker U.S. shale producers to capitulate, and is unwilling to adjust for Iranian supplies that should be coming to market soon. Also, Russia reaffirmed it would not cut a production deal with OPEC. For RBC Capital Markets' outlook for crude oil, see this report.
- Would **lifting the 40-year U.S. crude oil export ban** impact oil prices? It should be supportive for WTI prices versus Europe's Brent benchmark in the early stages—meaning, the gap between the two prices should narrow. But **we doubt WTI would climb back to its historical premium over Brent** because the Atlantic basin is awash in light sweet crude. At this stage, the destination for U.S. oil may be a short trip to Mexico. Refer to this report for RBC Capital Markets' thoughts about lifting the export ban.
- Positive fundamental developments unfolded in the industrials sector. **FedEx** reported better-than-expected fiscal Q2 earnings. Total revenue rose 5% y/y, slightly higher than analysts' forecasts, and ground shipping revenue surged 32% due to strong e-commerce volumes. **General Electric** and **Honeywell** issued solid 2016 guidance despite a challenging operating environment amid the ongoing commodity correction and the related manufacturing recession. GE forecasts double-digit earnings growth. In contrast, **3M** came up shy. The company cut its 2015 estimate and provided 2016 guidance that was a bit below the consensus forecast.

High-Yield Stress Has Not Yet Impacted Investment-Grade Bonds

Yield Spread of Corporate Bonds Over Treasuries (%)



Source - RBC Wealth Management, Bloomberg; data through 12/16/15

- **Volatility in the high-yield bond market diminished** during the week, but the sector's yield premium versus safe-haven Treasuries continued to creep higher. So far, high-yield stress has **not spread to other areas of the bond market**. For example, the yield spread of AA-rated investment-grade bonds has narrowed recently, in contrast to the widening of the high-yield spread (see chart).

CANADA

Patrick McAllister & Alana Awad – Toronto

- The **S&P/TSX Composite rallied modestly** despite weakness in the materials sector as **industrials outperformed**.
- **Canadian Pacific Railway (CP Rail) revised its offer for Norfolk Southern** for the second time in as many weeks. While the share and cash consideration remains unchanged, CP Rail **included a contingent value right component** to its bid that would result in a cash payment to Norfolk Southern shareholders in the event the combined company's share price trades below $175 during the relevant measurement period.
- **Canadian government bond yields** were roughly **unchanged** as the announcement of a rate hike in the U.S. was widely anticipated and calmly absorbed by most markets.
- The **Canadian dollar** continued to **trend lower** and declined over 1% since the Fed announced the rate hike. Continued weakness in oil prices also contributed to the loonie's weakness.

- The **preferred share market rallied** approximately 6% for the week. The **number of buyers surpassed the number of sellers** as valuations became increasingly attractive. The S&P/TSX Preferred Share Index had touched an all-time low on Monday.
- **Shaw Communications** announced the **proposed acquisition of WIND Mobile** for CA$1.6B. The **share price reacted negatively** in the wake of the announcement as the transaction would increase debt leverage and dilute free cash flow.
- **S&P placed Shaw's BBB- rating on CreditWatch Negative** following the announcement. We recommend holders of Shaw 2019 and 2020 bonds and Shaw preferred shares reduce exposure given the uncertainty around Shaw's credit rating.

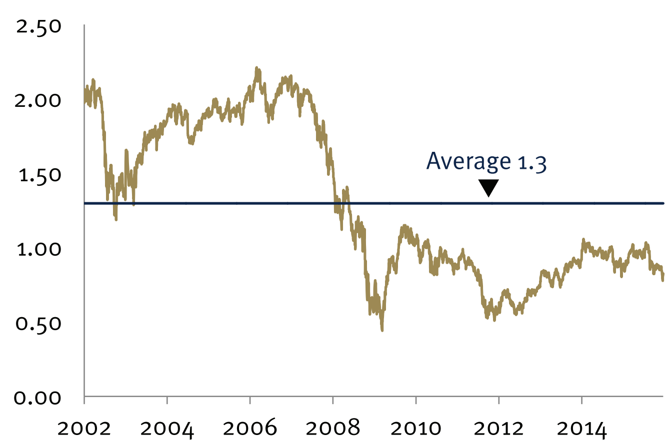
EUROPE

Frédérique Carrier & Davide Boglietti – London

- The **STOXX Europe 600** Index increased 1.5% during the week, **recovering some of the losses** incurred during December when the European Central Bank's renewed monetary stance failed to excite investors. **European banks**, still trading at a discount to their historical valuations, were the **main contributors** to the positive performance after recently lagging the market on the back of concerns for loan exposure to the struggling energy sector. Despite the Fed's rate hike, **interest rates in Europe did not move higher** and with the German Bund still yielding only 0.5%, the short-term **outlook for banks' net interest margins remains dull**.
- With oil prices continuing to fall, the **pressure on oil stocks did not abate.** While we expect that oil companies' 2016 budgets will be more considered given the current low price environment, **dividend cuts are still possible**.
- **Macroeconomic news in Europe was encouraging** with flash PMI estimates suggesting the **recovery is keeping pace and broad-based** across both manufacturing and services. French private sector activity appears stagnant in December, with a fall in services sector activity which could have been driven by last month's terrorist attacks in Paris.
- The Bank of England announced this week that **U.K. CPI inflation rose** 0.2% to stand at 0.1% y/y in November. The headline rate **returned to positive territory** after its brief spell below zero, in line with consensus and our economists' expectations. Lower oil prices may exert negative pressure on inflation over the coming months.

European Banks Remain at a Discount to Historical Valuations

Price-to-Book Ratio of the STOXX Europe 600 Bank Index



Source - RBC Wealth Management, Bloomberg; data through 12/18/15

ASIA PACIFIC

Yufei Yang – Hong Kong

- **China's economic data exhibited signs of stabilization** in November. Retail sales jumped 11.2% y/y, above the market's expectation of 11.1% and last month's 11%. A purchase tax cut in September helped auto sales continue to recover. Industrial production growth accelerated to 6.2% y/y from October's 5.6%, while fixed asset investment was flat at 10.2%. New-home prices climbed in 33 cities among the 70 cities tracked by the National Bureau of Statistics, up from 27 last month. New loans and money supply also exceeded analysts' forecasts.
- The yuan continued drifting lower. The dollar now buys 6.4815 yuan in Shanghai, the highest level in four years. On December 11, **the People's Bank of China introduced a new exchange rate index** that values the yuan against a basket of 13 trade-weighted currencies in order to **further de-peg the yuan from the dollar**. The dollar, euro, and yen account for 26.4%, 21.4%, and 14.7% of the basket, respectively.
- After reiterating its monetary easing target on Friday, the **Bank of Japan** (BoJ) introduced a **new exchange-traded fund (ETF) purchase program**, adding to the current ETF purchase program of ¥3T annually. Under the new program, the BoJ will purchase ETFs at an **annual pace of ¥300B** composed of stocks issued by companies "proactively making investment in physical and human capital." Meanwhile, exports dropped 3.3% y/y in November due to weakness in steel and organic chemicals.
- **Taiwan cut its benchmark interest rate** for a second straight quarter. The central bank lowered the rate by another 12.5 basis points to 1.625%. The decision came after recent data showed **exports** suffered their **largest decline since 2009**.

MARKET SCORECARD

Data as of December 18, 2015

Equities (local currency)	Level	1 Week	MTD	YTD	12 Mos
S&P 500	2,005.52	-0.3%	-3.6%	-2.6%	-2.7%
Dow Industrials (DJIA)	17,128.45	-0.8%	-3.3%	-3.9%	-3.7%
NASDAQ	4,923.08	-0.2%	-3.6%	3.9%	3.7%
Russell 2000	1,121.05	-0.2%	-6.4%	-6.9%	-6.0%
S&P/TSX Comp	13,024.30	1.8%	-3.3%	-11.0%	-9.2%
FTSE All-Share	3,348.10	1.6%	-4.1%	-5.2%	-3.6%
STOXX Europe 600	361.23	1.5%	-6.3%	5.5%	6.5%
German DAX	10,608.19	2.6%	-6.8%	8.2%	8.1%
Hang Seng	21,755.56	1.4%	-1.1%	-7.8%	-4.7%
Shanghai Comp	3,578.96	4.2%	3.9%	10.6%	17.1%
Nikkei 225	18,986.80	-1.3%	-3.9%	8.8%	10.3%
India Sensex	25,519.22	1.9%	-2.4%	-7.2%	-5.9%
Singapore Straits Times	2,852.84	0.6%	-0.1%	-15.2%	-12.0%
Brazil Ibovespa	43,910.60	-3.0%	-2.7%	-12.2%	-9.5%
Mexican Bolsa IPC	42,936.63	2.2%	-1.1%	-0.5%	1.1%

Commodities (USD)	Price	1 Week	MTD	YTD	12 Mos
Gold (spot $/oz)	1,066.30	-0.8%	0.1%	-10.0%	-11.0%
Silver (spot $/oz)	14.09	1.3%	0.1%	-10.2%	-11.3%
Copper ($/metric ton)	4,543.00	-3.4%	-1.2%	-28.7%	-28.6%
Oil (WTI spot/bbl)	34.73	-2.5%	-16.6%	-34.8%	-35.8%
Oil (Brent spot/bbl)	36.66	-3.3%	-17.8%	-36.1%	-38.1%
Natural Gas ($/mmBtu)	1.77	-10.9%	-20.7%	-38.6%	-51.3%
Agriculture Index	287.66	-0.5%	0.3%	-10.8%	-15.2%

Govt Bonds (bps chg)	Yield	1 Week	MTD	YTD	12 Mos
U.S. 2-Yr Tsy	0.948%	7.3	1.8	28.4	31.7
U.S. 10-Yr Tsy	2.199%	7.2	-0.7	2.8	-0.9
Canada 2-Yr	0.501%	1.9	-13.1	-51.1	-51.9
Canada 10-Yr	1.397%	-1.1	-17.3	-39.1	-47.1
U.K. 2-Yr	0.591%	1.6	-1.3	14.5	9.4
U.K. 10-Yr	1.831%	1.8	0.6	7.5	-3.9
Germany 2-Yr	-0.354%	-0.3	6.1	-25.6	-27.8
Germany 10-Yr	0.548%	0.8	7.5	0.7	-6.9

Currencies	Rate	1 Week	MTD	YTD	12 Mos
U.S. Dollar Index	98.71	1.2%	-1.5%	9.3%	10.6%
CAD/USD	0.72	-1.4%	-4.2%	-16.7%	-17.0%
USD/CAD	1.39	1.4%	4.4%	20.0%	20.5%
EUR/USD	1.09	-1.1%	2.8%	-10.2%	-11.6%
GBP/USD	1.49	-1.9%	-0.9%	-4.2%	-4.8%
AUD/USD	0.72	-0.2%	-0.7%	-12.2%	-12.1%
USD/CHF	0.99	1.0%	-3.6%	-0.2%	1.3%
USD/JPY	121.24	0.2%	-1.5%	1.2%	2.0%
EUR/JPY	131.74	-0.9%	1.3%	-9.1%	-9.8%
EUR/GBP	0.73	0.8%	3.8%	-6.2%	-7.1%
EUR/CHF	1.08	-0.3%	-0.8%	-10.4%	-10.5%
USD/SGD	1.41	0.0%	0.1%	6.6%	7.5%
USD/CNY	6.48	0.4%	1.3%	4.4%	4.3%
USD/BRL	3.98	2.8%	3.0%	49.9%	49.6%

Source - Bloomberg. Note: Equity returns do not include dividends, except for the German DAX. Bond yields in local currencies. Copper and Agriculture Index data as of Thursday's close. Dollar Index measures USD vs. six major currencies. Currency rates reflect market convention (CAD/USD is the exception). Currency returns quoted in terms of the first currency in each pairing. Data as of 8:35 pm GMT 12/18/15.

Examples of how to interpret currency data: CAD/USD 0.72 means 1 Canadian dollar will buy 0.72 U.S. dollar. CAD/USD -16.7% return means the Canadian dollar fell 16.7% vs. the U.S. dollar year to date. USD/JPY 121.24 means 1 U.S. dollar will buy 121.24 yen. USD/JPY 1.2% return means the U.S. dollar rose 1.2% vs the yen year to date.

UPCOMING EVENTS

MON, DEC 21

U.S. Chicago Fed Nat'l Activity

TUE, DEC 22

U.S. Existing-Home Sales (-0.5% m/m)

U.S. Q3 GDP Revision (1.9% q/q ann.)

WED, DEC 23

U.K. Q3 GDP Revision (0.5% q/q)

U.S. PCE Core (1.3% y/y)

U.S. Durable Goods (-0.4% m/m)

WED, DEC 23 (cont.)

U.S. New-Home Sales (1.0% m/m)

Canada October GDP

Canada Retail Sales

THU, DEC 24

Japan Nat'l CPI (0.3% y/y, Core 0.8%)

SAT, DEC 26

China Industrial Profits

SUN, DEC 27

China Leading Index

Japan Industrial Production

THU, DEC 31

China NBS Manufacturing PMI

China NBS Non-Manufacturing PMI

All data reflect Bloomberg consensus forecasts where available

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As of September 30, 2015

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Rating	Count	Percent	Count	Percent
Buy [Top Pick & Outperform]	958	54.40	281	29.33
Hold [Sector Perform]	701	39.81	118	16.83
Sell [Underperform]	102	5.79	4	3.92

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