June 8, 2017

RBC WEALTH MANAGEMENT

Global Insight Weekly

A closer look

The lopsided rally

Kelly Bogdanov – San Francisco

The high-flying U.S. equity rally of the past year has seen outperformance skewed toward one sector and five stocks in particular. But a lopsided surge like this isn't out of the ordinary, and we believe narrow market leadership is a sign the long-term bull market has stamina.

The major U.S. equity indexes have put together an impressive run since last summer with the S&P 500 and the Dow Jones Industrial Average both rallying 24%. But a rising tide doesn't always lift all boats. The advance has been more lopsided from a sector and stock standpoint than the broad indexes portray.

For those paying attention—and not distracted by the ongoing drama in Washington—it should be no surprise the Technology sector has been the driving force behind the market's advance. But the degree to which Tech has moved the market is eye-opening.

Since last year, Tech has delivered 36% of the S&P 500's gains (8.78 of 24.1 percentage points), followed by Financials with 22% of the gains (5.31 of 24.1 percentage points).

Three sectors—Consumer Discretionary, Industrials, and Health Care—have contributed to lesser degrees. The other six sectors have barely budged or detracted from performance (see chart).

When we dig deeper into S&P 500 stocks, the performance gets even more lopsided.

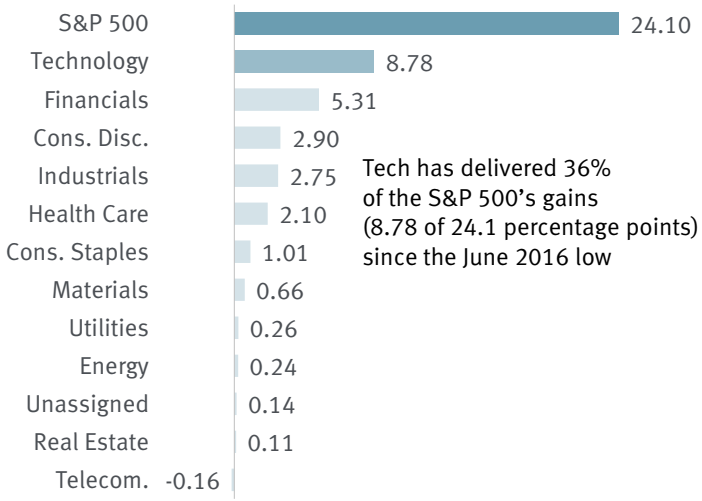
Just five high-flying stocks make up 33% of the S&P 500's gain year to date and 22% since last summer: Apple, Alphabet (Google), Amazon, Facebook, and Microsoft. Apple alone represents 12% of the S&P 500's year-to-date gain. Among the 25 stocks that have contributed most to the rally, 48% are members of the Tech sector.

Don't be narrow-minded

Should the major indexes' surge amid very narrow sector and stock leadership cause concern? We're not wringing our hands.

Tech and Financials have been the best performers

Sector contributions to the S&P 500 return since June 2016 low (%)



Source - RBC Wealth Management, FactSet; data through 6/7/17

Market pulse

Click here for authors' contact information.
Priced (in USD) as of 6/8/17 market close, EST (unless otherwise stated).
For important and required non-U.S. analyst disclosures, see Page 7.

RBC Wealth Management

It's important to put the index performance of the past year in perspective. It's not as extreme when viewed through a longer lens. While the S&P 500 has surged 24% since late June 2016, it has only advanced 17% total in the past two years, which roughly equates to the long-term average.

It's not unusual for a sector or two or a group of stocks to dominate a particular rally over the course of months or a year. For example, there have been periods of this long bull market cycle when defensive dividend-paying sectors have dominated, and when the Financials, Health Care, and Energy sectors have contributed significantly to broad index gains.

Going back a lot further, one of the most notable periods when a group of stocks dominated was the "Nifty Fifty" surge in blue-chip growth stocks in the 1960s and early 1970s.

Rotating sector and stock leadership is a common characteristic of U.S. equity bull market rallies, and it has been a hallmark of the current bull run that began in 2009.

Interestingly, the recent surge of the five high flyers hasn't had much impact on the market's valuation. The S&P 500 trades at 17.8x the 2017 consensus forecast whereas it trades at 17.3x excluding the five high flyers based on a bottom-up earnings calculation that adjusts for market capitalization.

Tech support

In our view, a key takeaway from the lopsided performance is that the Tech sector is ahead of itself and needs to digest the recent rally. In addition to racking up gains at an unsustainable rate, the sector's valuation has shifted from slightly undervalued to moderately overvalued since last August.

But the Tech's sector's 19.6x forward price-to-earnings (P/E) ratio is nowhere near the danger zone that occurred when the Tech Bubble formed around the turn of the century as the forward P/E ratio surged to 53x.

Despite the fact we think Tech could use a rest and we wouldn't chase it here, we believe it will be an important contributor of S&P 500 performance over the long term. The sector is the main source of the market's secular growth stocks and will likely continue to benefit from innovation and entrepreneurism.

Positive rotation

The market's narrow leadership demonstrates that a lot of sectors and stocks, including some widely owned household names, have not advanced as much in the past year as investors might perceive.

Therefore, it's supportive of our view that the bull market has further to run as other areas of the market take the leadership mantle at some point.

Typically during lengthy bull market cycles, sector and stock leadership shifts multiple times, which is why we recommend holding a diverse portfolio of U.S. equities for the long term.

Five stocks have dominated the S&P 500

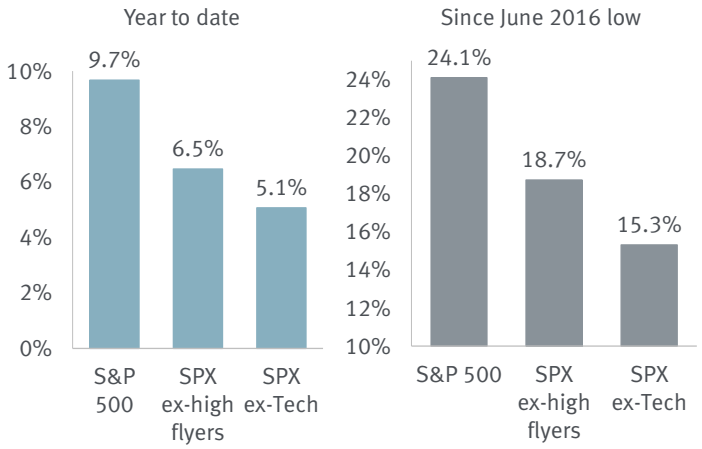
Top 25 S&P 500 stocks contributing to year-to-date return (%)

	Weight	Return	Contribution*
S&P 500	100.00	9.67	9.67
Apple	3.62	35.28	1.13
Alphabet Class A and C	2.54	53.50	0.63
Amazon.com	1.72	34.70	0.53
Facebook	1.62	33.09	0.47
Microsoft	2.52	17.86	0.43
Philip Morris	0.83	34.90	0.25
Johnson & Johnson	1.64	14.98	0.23
Comcast	0.89	21.84	0.19
Visa	0.81	23.61	0.18
Broadcom	0.42	44.51	0.16
Home Depot	0.88	16.95	0.14
McDonald's	0.54	26.53	0.13
NVIDIA	0.31	40.02	0.12
UnitedHealth Group	0.79	14.90	0.12
Oracle	0.64	19.05	0.11
Priceline	0.42	28.94	0.11
Mastercard	0.53	21.74	0.11
Medtronic	0.54	21.35	0.11
Boeing	0.50	22.82	0.11
Adobe Systems	0.31	39.50	0.10
PepsiCo	0.78	13.41	0.10
Netflix	0.31	33.77	0.09
Merck	0.87	9.61	0.09
CSX	0.22	50.76	0.09
Procter & Gamble	1.14	7.23	0.09

* "Contribution" is the price return multiplied by the individual weight of each S&P 500 stock. It demonstrates the absolute return impact of the individual stock on the S&P 500. Example: Apple's contribution represents 1.13 of the 9.67 percentage point return of the S&P 500. Said another way, Apple represents 12% of the S&P 500 return (1.13/9.67).
Source - RBC Wealth Management, FactSet; data through 6/7/17; Tech stocks shaded in gray, Amazon is a Consumer Discretionary stock

High flyers and Tech have had an outsized impact

S&P 500 returns excluding high flyers and the Tech sector



Note: High flyers are the top five stocks that have contributed to the S&P 500 gain: Apple, Alphabet (Google), Amazon, Facebook, and Microsoft
Source - RBC Wealth Management, FactSet; data through 6/7/17

United Kingdom in focus

U.K. election: As the case May be

Frédérique Carrier, Jamie Hayes, & Jack Lodge – London

The U.K.'s general election campaign has taken an unexpected twist in recent weeks, as the much anticipated Conservative Party landslide has become more uncertain with Labour showing a resurgence in the polls. We see three potential outcomes to the June 8 election.

Conservative majority

Should there be a Conservative majority, its extent will be key. The average of the past 15 polls points to Prime Minister Theresa May extending her majority to some 50 seats, from the current working majority of 17.

This scenario seems to be discounted in financial markets. Under this scenario Conservatives would plough on with a "hard Brexit." Our expectation remains for the U.K. economy to weaken somewhat as household disposable income is squeezed and for the Bank of England (BoE) to remain accommodative.

A larger majority in the House of Commons would be well received, as markets like a "strong government," and likely lead to a small relief rally in the pound. For equities, this would hold back the performance of exporters. In fixed income, the safe-haven trade for Gilts would unwind and corporate spreads would narrow. In the long term, concerns regarding the hard Brexit stance would prevail, with economic uncertainty keeping Gilts well underpinned but volatility remaining high for corporate bonds.

Narrow majority or Conservative minority government

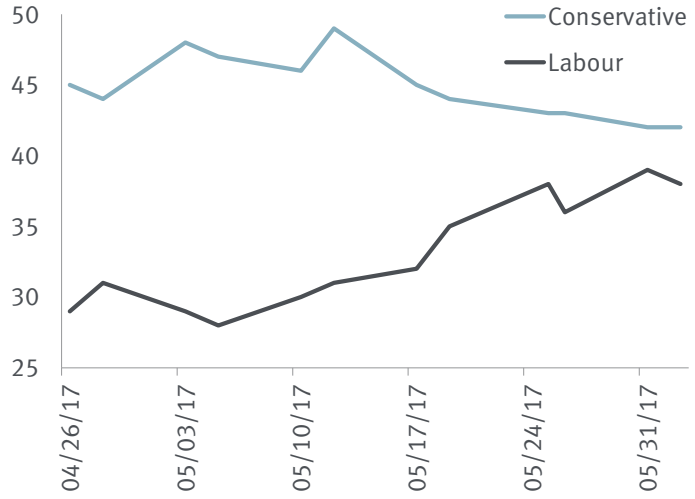
This is a possible but lower probability outcome. May's leadership would likely be challenged within her party, while the Conservatives would be forced to deal with an emboldened opposition.

May's tone towards Brexit negotiations has hardened markedly during the campaign, and she would likely have to honour her promises. The probability would increase that the U.K. crashes out of the EU with no trade agreement in place after the expiration of the 2-year negotiating window and operates under the auspices of the WTO, damaging trade in the short term due to both tariff and complicated and costly non-tariff barriers.

Under this scenario sterling would weaken, reaffirming our bias for exporters in equities. But it would be broadly neutral for Gilts, while the uncertainty of Brexit negotiations would create a more volatile environment for corporate bonds.

The Conservatives' lead has narrowed

YouGov poll on voting intentions in U.K. elections (%)



Source - RBC Wealth Management, Bloomberg; data through 6/2/17

Labour-led coalition

This is an unlikely scenario, though given Labour's rapid ascent in the polls, as well as its left-leaning tendencies, it needs to be considered. Labour could try to form a coalition with other parties, including the Scottish National Party.

This scenario would see the pound substantially weaken due to economic uncertainty as foreign investors flee the unfriendly environment. The Labour manifesto calls for higher government debt and taxes, a stark departure from the recent macroeconomic policies. While Labour's Brexit strategy is unclear, it would probably be more conciliatory.

We would expect a sharp correction in equities as stock prices adjust to an environment of increased corporate taxes, higher minimum wages, and nationalization. In the short term Gilts may benefit from a flight to safety. However, in the long term the greater Gilt issuance necessary to finance spending, along with higher inflation from a weaker pound, would lead the BoE to tighten monetary policy and be detrimental for Gilts. This environment would be unambiguously negative for corporate bonds, particularly in industries susceptible to government intervention, such as transport.

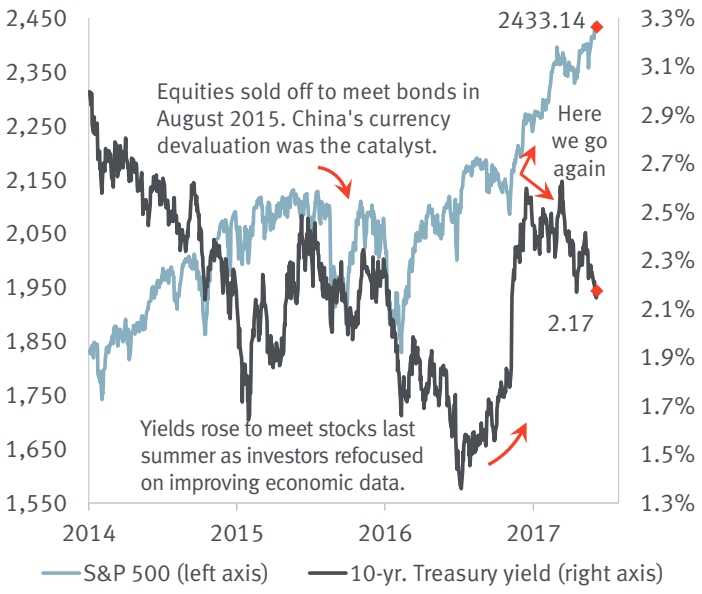
As the case may be, while centrist politicians seem to be regaining ground on the Continent, the U.K.'s politics have become more extreme.

United States

Sean C. Gray – Minneapolis

- **There they go again—stock prices and bonds yields are diverging**. The S&P 500 continues to march higher as bulls buy into the thesis that a solid economic backdrop and rising corporate profits will sustainably fuel the rally. Yet the 10-year Treasury yield has fallen 44 basis points from its March high of 2.63%, as bears pile into government bonds on concerns that the past year's economic momentum is waning, pro-growth policy will not materialize, inflation will not reach the Fed's 2% target, and the next recession looms on the not-too-distant horizon. **As seen in years past, something's gotta give**.
- **We suspect that either stocks fall**, as was the case during the summer of 2015 when a Chinese currency devaluation unnerved equity investors, **or yields rise**, as was the case last summer when moving beyond Brexit allowed investors to refocus on improving U.S. economic data. The eventual resolution likely depends on the following factors.
- **Bulls will look for a reflation trade resurgence**. A reassertion of confidence in the U.S. economy from Fed Chair Janet Yellen during her remarks following the June 14 meeting of the Federal Open Market Committee, as well as a reiteration of plans to move forward with monetary policy normalization would be a start. An eventual drawdown of U.S. crude oil inventories would not only help to bolster oil prices and the Energy sector, in our view, but also raise inflation expectations and steepen the yield curve, thereby supporting bank profitability and rejuvenating the flailing Financials sector. Robust Q2 GDP would also help to dispel lingering hard data concerns.
- **Bears will look for trepidation from Yellen, which would suggest that the U.S. remains mired in a low-growth status**. Sustained inaction from Washington may eventually have a deleterious effect on consumer and business confidence, thereby resolving the hard/soft data debate in a dismal conclusion. Finally, China concerns may again come to the fore, as its manufacturing sector recently flagged signs of contraction while its government seems intent on curtailing excessive lending.

Something's gotta give



Source - RBC Wealth Management, Bloomberg; data through 6/7/17

Canada

Alicia Buckiewicz & Farazeh Mahboob – Toronto

- **Oil prices fell below $46 per barrel** during the week after an influx of bearish news. The U.S. government reported an increase in crude oil inventories, rather than the expected draw, as refinery runs declined and exports fell. The **market has also come under pressure** from increased output from Nigeria and Libya, countries exempt from the production cuts made by OPEC and its 11 partners. There have been additional worries that the current OPEC production cuts could be undermined following news that some OPEC countries have cut diplomatic ties with one of its producers, Qatar. Finally, gasoline **demand in the U.S. appears light** ahead of the busy summer driving season.
- **Sales of existing homes** across the Greater Toronto Area **dropped 20% y/y** in May, while the **average home price** in the region **fell roughly 6% m/m**. These are the first results following the implementation of the Ontario Fair Housing Plan by the Ontario government. It is worth noting that these **declines follow significant price acceleration** over the past year, with the Toronto market not reporting meaningful declines in both price and sales since the recession of 2008. While active listings rose 43% y/y in May, the comparison month of May 2016 was a record low. We acknowledge that **current housing risks are elevated**, but we remain optimistic the market is only experiencing a healthy pullback. We believe there would need to be a shock to economic fundamentals for a real correction to occur; however, both Toronto and Vancouver are still showing solid population and income growth.

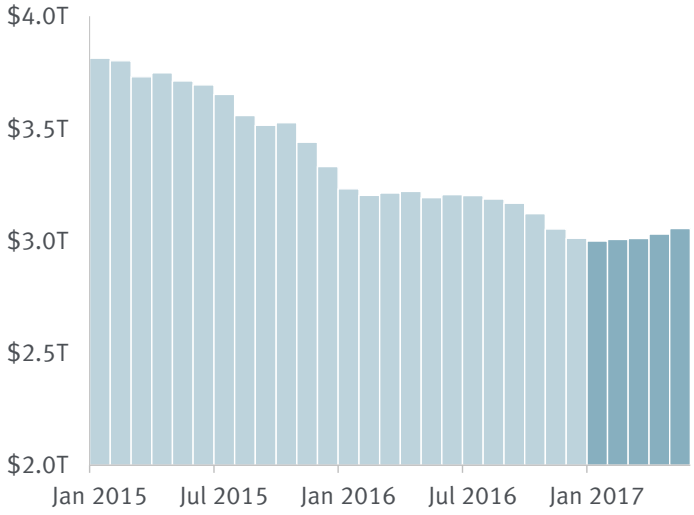
Europe

Frédérique Carrier & Thomas McGarrity – London

- **The European Central Bank** (ECB) kept its **policy unchanged** at its June 8 meeting but **tweaked its forward guidance**, omitting from the policy statement that the path of interest rates could go "lower." The ECB upgraded its risk assessment of eurozone growth to "broadly balanced," a shift from the previous assessment that risks were tilted to the downside, alongside nudging up its GDP growth forecasts by 0.1% a year out to 2019. Despite the improving growth outlook, the ECB cut its inflation forecasts to reflect lower oil prices. **The language around inflation also remained cautious**, with ECB President Mario Draghi reiterating that underlying inflation remains low, with no convincing signs of a pickup due to subdued wage growth. We expect the ECB to maintain its overall dovish stance until there is an indication of a conclusive rebound in core inflation.
- **Banco Santander, Spain's biggest bank, rescued ailing domestic rival Banco Popular** (POP), taking it over for a nominal fee of just €1.00. The move came after POP was determined to be "failing or likely to fail" by the EU's Single Resolution Board (SRB). This is a **landmark transaction** since it is the first time the SRB has used its powers following its creation in 2015 to deal with failing European banks, providing a **blueprint for what can be expected from the regulator**. A key part of the toolkit is the ability of regulators to impose losses on creditors. In the case of POP, contingent convertible bonds (AT1)—instruments designed to absorb losses—were wiped out for the first time, along with junior bondholders and shareholders. The move was reasonably isolated, with no significant impact on AT1 bonds issued by other European banks.
- **Shares of pharmaceutical giant Roche declined 6%** after data from its high-profile breast cancer **APHINITY trial fell short of market expectations**. Feedback from physicians was that they expected Roche's Perjeta drug would be used in high-risk patients only, rather than becoming part of the standard of care to treat neoadjuvant breast cancer.

After two straight years of decline in China's foreign reserves, it's trending higher so far in 2017

China's foreign exchange reserves (US$)



Source - RBC Wealth Management, Bloomberg; monthly data through 5/31/17

Asia Pacific

Jay Roberts – Hong Kong

- **The Reserve Bank of Australia** (RBA) left its **benchmark rate unchanged** at 1.5%. The RBA expects **economic growth "to increase gradually** over the next couple of years to a little above 3 per cent." However, the RBA also noted that growth in total hours worked remains "weak" and growth in real wages is "slow."
- RBC Capital Markets notes that the sluggishness in labour costs means that there is a **risk that core inflation stays below the RBA's 2%–3% range** for longer, and that there is a **possibility for a final 25 basis point rate cut in Q4**. RBC Capital Markets forecasts the Australian dollar to decline modestly against both the U.S. and Canadian dollars.
- **China's FX reserves rose** by $20.4B in May to $3.05T. This was the fourth consecutive month of increases in reserves, at their **highest level since October 2016**. However, a large part of this increase was due to movements in currency. Reserves are up by $43B thus far in 2017. This compares to very large declines in both 2016 ($320B) and 2015 ($512B).
- Although China's reserves are up in 2017, the country is **still experiencing capital outflow, albeit at a much slower pace** than in 2016 and 2015. Estimates suggest that capital outflows are currently less than half of the rate of those two years. There are various reasons for the improvement, including a stronger economy, higher local interest rates, less concern around rapid currency depreciation, and tighter controls around movements of money.
- **For equity investors, the important point is that capital outflow has moderated** to a degree. Previous episodes of larger outflows had impacted equity market performance, sometimes significantly such as at the start of 2016 when concerns played a central role in the global equity market correction.

MARKET SCORECARD

Data as of June 8, 2017

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,433.79	0.9%	8.7%	14.8%	17.0%
Dow Industrials (DJIA)	21,182.53	0.8%	7.2%	17.6%	19.2%
NASDAQ	6,321.76	2.0%	17.4%	27.1%	25.9%
Russell 2000	1,415.61	3.3%	4.3%	19.1%	12.9%
S&P/TSX Comp	15,423.09	0.5%	0.9%	7.8%	4.6%
FTSE All-Share	4,076.65	-1.0%	5.3%	17.8%	10.1%
STOXX Europe 600	389.15	-0.2%	7.7%	12.9%	1.0%
German DAX	12,713.58	0.8%	10.7%	24.4%	14.9%
Hang Seng	26,063.06	1.6%	18.5%	22.4%	-4.6%
Shanghai Comp	3,150.33	1.1%	1.5%	7.6%	-38.6%
Nikkei 225	19,909.26	1.3%	4.2%	18.3%	-2.7%
India Sensex	31,213.36	0.2%	17.2%	15.5%	17.7%
Singapore Straits Times	3,237.05	0.8%	12.4%	13.1%	-2.5%
Brazil Ibovespa	62,755.57	0.1%	4.2%	21.6%	18.8%
Mexican Bolsa IPC	49,087.46	0.6%	7.5%	6.1%	10.2%

Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot $/oz)	1,279.23	0.8%	11.0%	1.3%	9.0%
Silver (spot $/oz)	17.45	0.7%	9.6%	2.4%	9.1%
Copper ($/metric ton)	5,591.75	-1.2%	1.2%	22.4%	-5.8%
Oil (WTI spot/bbl)	45.64	-5.5%	-15.0%	-10.9%	-21.5%
Oil (Brent spot/bbl)	47.90	-4.8%	-15.7%	-8.8%	-23.6%
Natural Gas ($/mmBtu)	3.04	-1.1%	-18.4%	23.1%	12.3%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	2.192%	-1.1	-25.2	49.0	-19.0
Canada 10-Yr	1.418%	0.2	-30.3	21.7	-39.6
U.K. 10-Yr	1.033%	-1.3	-20.6	-22.0	-101.2
Germany 10-Yr	0.256%	-4.8	4.8	20.1	-62.3
Fixed Income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	2.47%	0.1%	2.5%	1.0%	6.1%
U.S. Invest Grade Corp	3.15%	0.2%	3.7%	3.4%	10.1%
U.S. High Yield Corp	5.50%	0.2%	5.0%	12.5%	13.8%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	96.9610	0.0%	-5.1%	3.6%	1.7%
CAD/USD	0.7406	0.0%	-0.5%	-6.0%	-8.1%
USD/CAD	1.3502	0.0%	0.5%	6.4%	8.8%
EUR/USD	1.1214	-0.3%	6.6%	-1.6%	-0.7%
GBP/USD	1.2948	0.4%	4.9%	-10.7%	-15.6%
AUD/USD	0.7547	1.6%	4.7%	1.0%	-2.0%
USD/CHF	0.9676	0.0%	-5.0%	0.9%	4.3%
USD/JPY	109.9700	-0.7%	-6.0%	2.8%	-11.7%
EUR/JPY	123.3200	-1.0%	0.3%	1.2%	-12.3%
EUR/GBP	0.8661	-0.7%	1.5%	10.3%	17.7%
EUR/CHF	1.0851	-0.3%	1.2%	-0.7%	3.6%
USD/SGD	1.3808	-0.2%	-4.6%	2.5%	2.0%
USD/CNY	6.8003	-0.3%	-2.1%	3.6%	9.6%
USD/BRL	3.2635	1.1%	0.3%	-2.9%	4.9%

Source - Bloomberg. Note: Equity returns do not include dividends, except for the German DAX and Brazilian Ibovespa. Bond yields in local currencies. Copper Index data and U.S. fixed income returns as of Wednesday'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 6/8/17.

Examples of how to interpret currency data: CAD/USD 0.74 means 1 Canadian dollar will buy 0.74 U.S. dollar. CAD/USD -0.5% return means the Canadian dollar fell 0.5% vs. the U.S. dollar year to date. USD/JPY 109.97 means 1 U.S. dollar will buy 109.97 yen. USD/JPY -6.0% return means the U.S. dollar fell 6.0% vs. the yen year to date.

UPCOMING EVENTS

Fri, Jun 9

Germany Exports/Imports
U.K. Industrial Prod. (0.7% m/m)
U.K. Manuf. Prod. (0.8% m/m)
U.K. NIESR GDP Estimate
U.S. Wholesale Inventories (-0.3% m/m)
Canada Capacity Utilization (83.5%)
Canada Unemployment (6.6%)

Mon, Jun 12

China Q3 Manpower Survey

Tue, Jun 13

China Retail Sales (10.7% y/y)
China Fixed Assets (8.8% YTD y/y)
China Industrial Production (6.4% y/y)
Eurozone ZEW Surveys
Germany ZEW Surveys
U.K. CPI (2.7% y/y)
U.K. House Price Index
U.S. NFIB Small Bus. Optimism (105.0)

Wed, Jun 14

Japan Industrial Production
Eurozone Industrial Production
Eurozone Employment
Germany CPI
U.K. ILO Unemployment (4.6%)
Fed Meeting
U.S. CPI (0.0% m/m, 1.9% y/y)
U.S. CPI ex. Food/Energy (0.2% m/m)
U.S. Core CPI

Wed, Jun 14, cont.

U.S. Real Avg. Weekly Earnings
U.S. Retail Sales (0.1% m/m)

Thu, Jun 15

BoE Meeting
U.K. Retail Sales
U.S. Industrial Production (0.0% m/m)
U.S. NAHB Housing Market Index (70)

Fri, Jun 16

BoJ Meeting

The dates reflect North American time zones. All data reflect Bloomberg consensus forecasts where available.

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