February 14, 2019

RBC WEALTH MANAGEMENT

A closer look

Wellness profile of the U.S. banks

Kelly Bogdanova – San Francisco

The banks have bounced back smartly after being stricken by underperformance in 2018. And while there are some risks to monitor, we see six traits that portend a healthy constitution for the banks in the coming year and reinforce our positive outlook.

Following a tough 2018, U.S. bank stocks have outperformed since the December 24 correction low. While they may be in store for a consolidation period just like the broader market, RBC Capital Markets continues to recommend bank stocks and we still favor them in the U.S. equity portion of portfolios.

Six key reasons we like bank stocks:

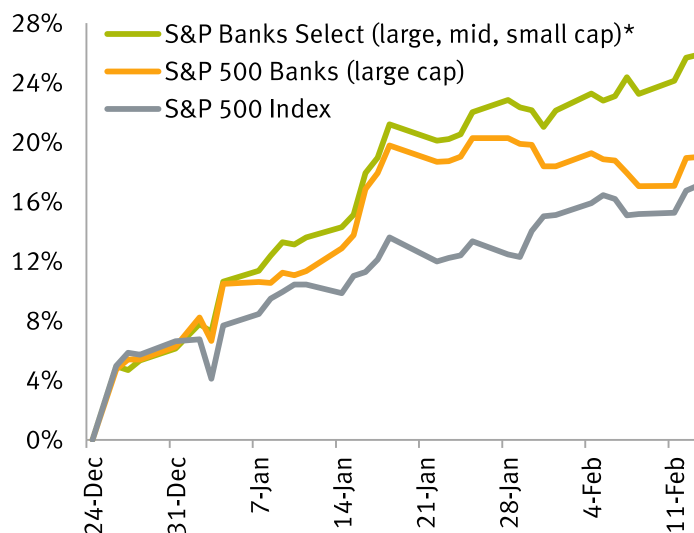
(1) Balance sheet bulwarks: Banks' capital levels are the strongest since the 1930s. A measure of risk and capitalization for commercial banks, the industry's tangible common equity ratio, reached 9.2% in Q3 2018, well above the roughly 7.4% peak in the prior two expansion cycles. This is much improved compared to the financial crisis when the ratio dropped to 6.3% overall and was dire for some banks. This industry measure was even lower in the early 1980s at 5.8%.

(2) Stable economic environment: Forward-looking indicators continue to signal the U.S. economy is in the late-cycle phase, not at the end of the expansion cycle or soon headed toward recession. While some manufacturing and consumer trends cooled in December, RBC's economists believe GDP has the potential to grow above 2% this year. U.S. banks are positioned to benefit from a stable economy, in our view. The overwhelming proportion of S&P banks of all capitalizations are heavily, if not totally, exposed to the domestic market. They are largely shielded from the current growth concerns in Europe and China.

(3) Favorable fundamentals: This year commercial bank loan growth should climb above the roughly 5% rate in 2018, and this should lead to solid revenue growth, according to Gerard Cassidy, Head of U.S. Bank Equity Strategy & Analyst at RBC Capital Markets, LLC. The combination of higher loan growth and disciplined expense management should lead to positive

Banks outperforming since the Christmas Eve market bottom

U.S. bank indexes versus the S&P 500



* The S&P Banks Select Industry Index comprises 85 bank and related stocks in the S&P Total Market Index, including large, mid, small, and micro cap.
Source - RBC Wealth Management, Bloomberg; data through 2/13/19

Market pulse

3 Chilly holiday shopping season in the U.S.
3 Checking in on the Canadian banks
4 Will the U.S.-EU trade truce continue?

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Priced (in USD) as of 2/14/19 market close, EST (unless otherwise stated).
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Wealth Management

operating leverage and improved profitability in 2019. In his assessment, consumer and commercial credit quality trends should not deteriorate in the near term. More stock buybacks seem likely to materialize, and there are already some big programs in the pipeline, especially at Bank of America.

Importantly, Cassidy believes better loan growth should make up for weaker fundamental metrics. For example, net interest margins—a measure of profitability—have likely peaked. Also, following the Fed's rate hikes, banks are paying more for deposits. Therefore, profit margins will likely slip this year, but stronger loan growth should offset this, in Cassidy's view.

(4) Manifestation of M&A: The long-awaited merger and acquisition (M&A) catalyst burst onto the scene with two high-profile deals so far this quarter: BB&T and SunTrust agreed to merge, forming a combined entity valued at about $66B, and Chemical Financial agreed to acquire TCF Financial for $3.6B in stock. The industry is on track for its best M&A volume quarter since 2007, and it's only halfway through the period (see upper chart).

RBC Capital Markets anticipates additional bank M&A, including sizeable deals, for three main reasons. The ongoing requirement to digitize the industry demands scale and is not cheap; expense efficiencies and economies of scale usually arise with mergers; and while regulatory burdens are lighter overall they are still demanding for many banks. M&A helps banks tackle these three issues.

(5) Visible value: U.S. bank valuations are still attractive on price-to-book (P/B) and price-to-earnings (P/E) bases. Cassidy believes there is room for multiple expansion. The forward P/E is slightly below its long-term average and is at a greater-than-normal discount to the S&P 500. He anticipates the S&P 500 Banks Index can rise to a P/B of 2.25x during this cycle versus the current 1.67x level if M&A heats up and the industry fundamentals and economy remain on firm footing (see lower chart).

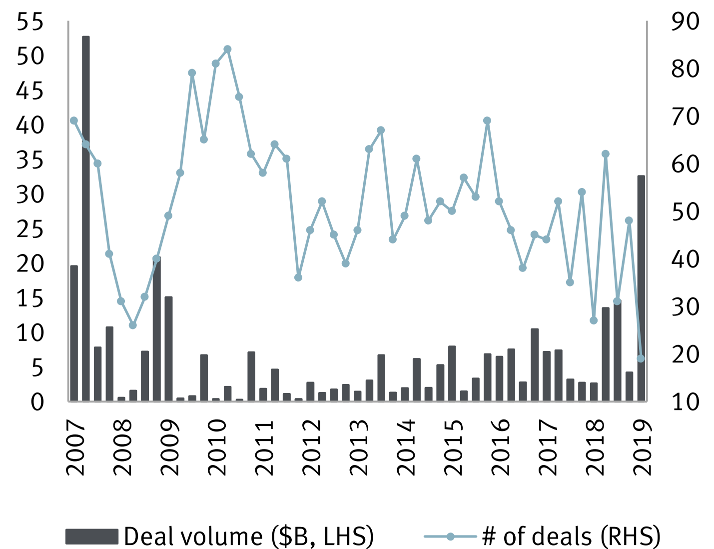
(6) Limited loan vulnerability: Banks are not exposed much to subprime auto loans, leveraged loans, and student loan debt. These more vulnerable loan categories are largely held outside of the traditional banking system.

As always, there are risks to the bullish thesis. If the domestic economy turns south, bank loan and revenue growth would be vulnerable. Conversely, if the economy heats up too much, it could stoke inflation and/or prompt the Fed to push rates up too far, too fast. At this stage, RBC's economists don't see these scenarios unfolding this year.

We think the six catalysts for bank shares outweigh the risks. The group remains attractive due to strong fundamental prospects, the likelihood of more M&A, reasonable valuations with potential for multiple expansion, and because they represent a good cyclical play on the U.S. economy.

Bank M&A volume has spiked this quarter

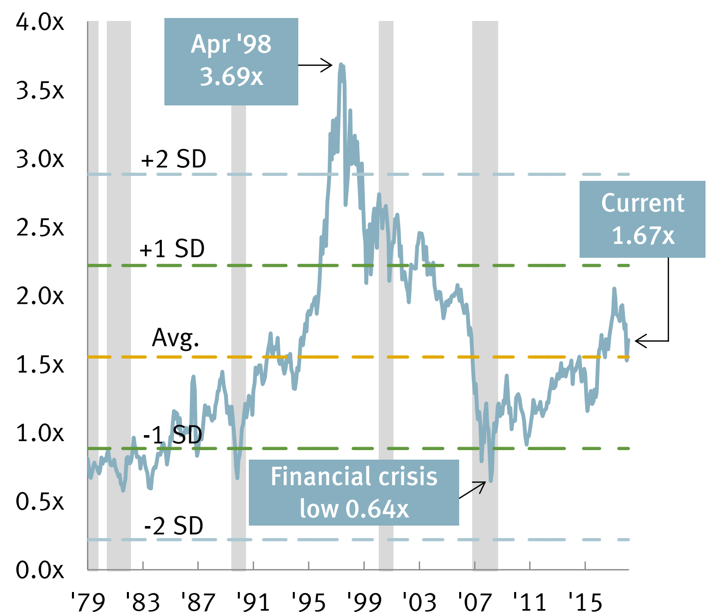
U.S. bank merger and acquisition (M&A) trends by quarter



Source - RBC Wealth Management, Bloomberg; data through 2/13/19. Q1 2019 data (far right bar and dot) is preliminary and subject to revision should more deals be announced.

Bank valuations could expand further

S&P 500 Banks Index price-to-book (P/B) ratio



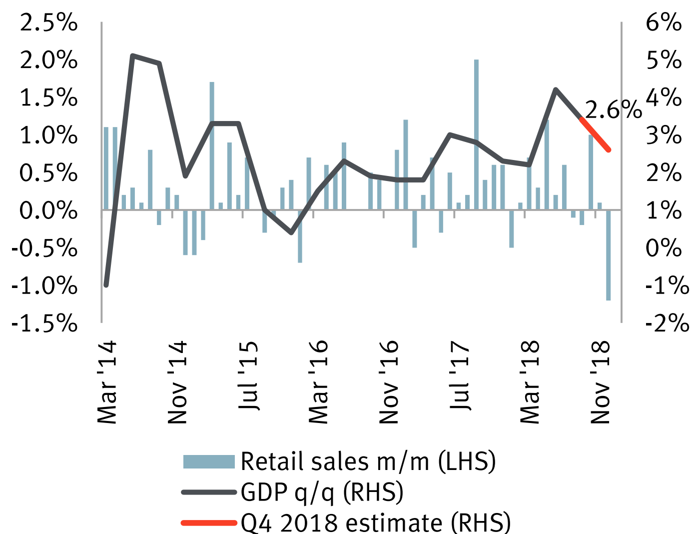
Note: Gray shaded areas represent recession periods. "SD" is standard deviation.
Source - RBC Capital Markets Quant Team, FactSet; monthly data through 2/13/19. Data adjusted as of 3/31/14 due to addition of JPM, C, and BAC to the index.

United States

Bill Kuehn, CFA – Minneapolis

- Economic data releases that were delayed by the government shutdown continue to trickle in slowly, but it was the release of December's retail sales number that caught investors' attention. **Retail sales fell 1.2% m/m in December**, for the largest monthly decline since 2009 during the depths of the financial crisis. Given consumer spending is the driver of U.S. economic growth, **the decline in December retail sales caused substantial downward revisions to Q4 GDP estimates**; the Bloomberg consensus estimate declined to 2.6% q/q, a distinct slowdown from the 3.4% q/q pace in Q3 2018.
- Despite the period marking the end of the holiday shopping season, the decline in retail sales was broad-based and likely resulted from a mix of factors. Gasoline prices that fell over 7% in the month failed to boost discretionary spending elsewhere amid the government shutdown and stock market turmoil. **Consumers appear to have increased spending only on automobiles and building materials**, while cutting spending on everything else.
- Equity markets initially sold off following the release, with the S&P 500 opening down 18 points, and Treasury yields fell across the yield curve as investors shifted to assets seen as safer. However, stocks slowly recovered lost ground throughout the trading session, as investors viewed the data as a temporary stumble rather than a sign of broader economic weakness. Although the U.S. is in the 10th year of the current economic expansion, **our view remains that the economy will just experience a *slowdown* in economic growth in 2019 from the robust pace of 2018, and that the risk of a recession remains low**.
- **The significant pullback in retail sales stands in contrast to the acceleration in wage growth**, which increased at a 3.2% y/y pace in the January jobs report. Recent developments suggest **the consumer spending slump could linger into the first half of 2019**, in our view, due to the extended government shutdown as well as the potential "sticker shock" of smaller-than-expected tax refunds due to updated tax withholding tables from the Tax Cuts and Jobs Act that was enacted at the beginning of last year.

Q4 GDP estimates slashed following largest monthly decline in retail since 2009



Source - RBC Wealth Management, Bloomberg; data through 2/14/19

Canada

Carolyn Schroeder & Richard Tan, CFA – Toronto

- While the Canadian banks finished 2018 in negative territory, they still managed to outperform the S&P/TSX Composite on a relative basis. **Year-to-date the banks have rebounded from their December lows** and have performed in line with the broader markets. RBC Capital Markets continues to expect slower earnings growth going into FY2019 driven by softer loan growth and a pickup in credit provisions. On the latter, RBC Capital Markets remains cautious on the credit environment but notes that it has not seen any significant signs of deterioration. **Valuation appears attractive** with the banks trading at 10.2x forward earnings versus the historical average of 11.5x. For those looking for exposure, **we recommend allocating capital to banks with a greater U.S. footprint** given the inherent domestic challenges and volatility within crude oil markets, which could impact energy loan books. The Canadian banks will likely begin reporting Q1 2019 results on February 26.
- **Global oil prices recently stabilized, but the market appears to be weighing the probability of a recession-induced supply surplus or a recovery-driven deficit**. In January, OPEC and its partners (a group of non-OPEC nations led by Russia) agreed to cut 800,000 and 400,000 barrels of oil per day from the market, respectively, for a period of six months. Such measures were taken in an attempt to prevent another price-crushing oil glut like the one that gripped the market in 2014 and 2016. OPEC's recent production cuts coupled with U.S. sanctions on Iran and Venezuela have somewhat offset the feared slowdown in global oil consumption. The difference in price between Western Canadian Select (WCS) and West Texas Intermediate (WTI) widened to as much as $52 per barrel in October, but shrunk to single digits in

December and January. **For the WTI-WCS differential to tighten from its current $10.90 level, production in Canada would need to decrease and/or export capacity would need to increase. The first of these two key drivers is already playing out in Alberta,** which should benefit heavy oil producers. Even so, RBC Capital Markets retains an upward bias and is forecasting a WTI-WCS differential of $19/barrel in 2019.

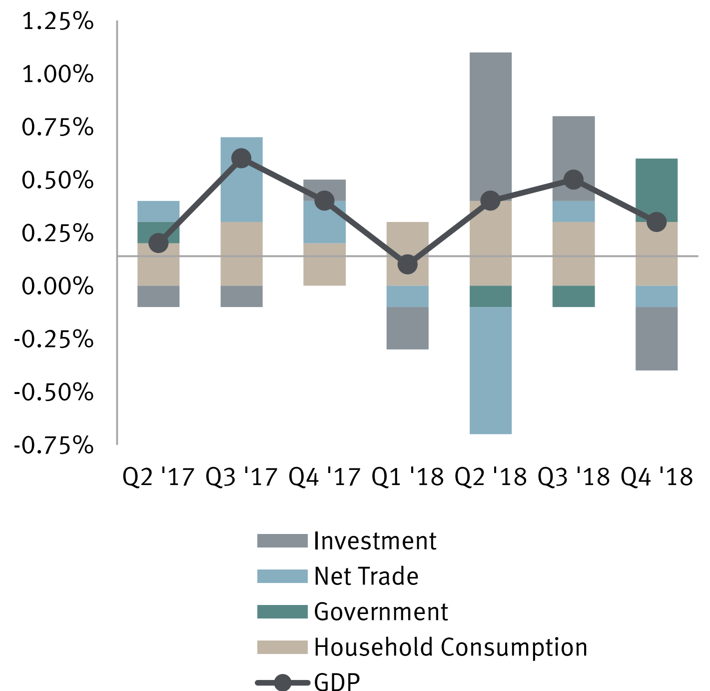
Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- **U.K. GDP grew by a meagre 0.2% q/q in Q4 2018**, a sharp slowdown from the 0.4% and 0.6% expansions recorded in Q2 and Q3, respectively, and **below consensus expectations**. According to the Office for National Statistics, this would leave growth at 1.4% y/y for 2018, the lowest level since 2012. **The biggest drag is investment, which saw its decline accelerate** to -1.4% q/q and detracted 0.3% from GDP, its fourth consecutive quarterly decline, **probably due to Brexit uncertainty**. Until there is more visibility on that front, we believe this trend is unlikely to reverse. For the Bank of England and monetary policy, the next move will be determined by the nature of the U.K.'s exit from the EU.
- In Europe, policymakers are eagerly awaiting **a U.S. Department of Commerce report considering whether EU automotive and auto-part imports threaten U.S. national security**. The report, expected mid-February, could determine whether the trade truce between the U.S. and the EU will last. If the Department of Commerce deems the European imports a threat to national security, **President Trump could threaten the EU with 25% automotive import tariffs**.
- Beyond the noise, with **both sides having much to lose from a growing conflict and with not much appetite in the U.S. for a trade war against the EU**, in contrast to the attitude toward China, we would expect these tensions to ease eventually.

Investment continues to be the largest drag on U.K. economic growth

Contributions to U.K. economic growth



Source - RBC Wealth Management, Bloomberg; data through 2/11/19; note contributions to GDP are major components; not inclusive of all components

- The likelihood of snap elections in Spain has increased further, as the government failed to get the backing of Catalan parties on which it has relied to pass legislation. **The political backdrop in Spain is very fractured** and current polls suggest **a coalition between centrist Ciudadanos and the centre-right Partido Popular to form a government is most likely**. Such an alliance **would likely be positive for the economy**, in our view, and would not endanger the substantial reform effort undertaken since the financial crisis.

MARKET SCORECARD

Data as of February 14, 2019

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,745.73	1.5%	9.5%	1.7%	17.5%
Dow Industrials (DJIA)	25,439.39	1.8%	9.1%	2.2%	24.1%
NASDAQ	7,426.96	2.0%	11.9%	4.0%	28.4%
Russell 2000	1,545.11	3.0%	14.6%	1.5%	10.6%
S&P/TSX Comp	15,695.98	1.0%	9.6%	2.4%	-0.6%
FTSE All-Share	3,934.29	2.8%	7.1%	-0.8%	-0.6%
STOXX Europe 600	363.80	1.4%	7.7%	-2.9%	-1.7%
EURO STOXX 50	3,182.66	0.7%	6.0%	-5.6%	-3.8%
Hang Seng	28,432.05	1.8%	10.0%	-6.8%	20.0%
Shanghai Comp	2,719.70	5.2%	9.1%	-15.0%	-15.5%
Nikkei 225	21,139.71	1.8%	5.6%	-0.1%	9.9%
India Sensex	35,876.22	-1.0%	-0.5%	5.0%	26.6%
Singapore Straits Times	3,253.16	2.0%	6.0%	-4.4%	5.9%
Brazil Ibovespa	98,015.09	0.6%	11.5%	17.3%	46.9%
Mexican Bolsa IPC	42,725.22	-2.9%	2.6%	-11.7%	-9.8%

Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot $/oz)	1,312.60	-0.7%	2.4%	-2.8%	6.9%
Silver (spot $/oz)	15.62	-2.8%	0.8%	-7.3%	-13.0%
Copper ($/metric ton)	6,123.50	-0.5%	2.9%	-14.0%	2.0%
Oil (WTI spot/bbl)	54.41	1.2%	19.8%	-10.2%	2.3%
Oil (Brent spot/bbl)	64.62	4.4%	20.1%	0.4%	15.5%
Natural Gas ($/mmBtu)	2.58	-8.5%	-12.4%	-0.4%	-11.3%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	2.652%	2.3	-3.2	-25.0	18.2
Canada 10-Yr	1.876%	-0.3	-9.1	-49.7	10.9
U.K. 10-Yr	1.150%	-6.9	-12.7	-49.0	-16.0
Germany 10-Yr	0.103%	-4.6	-13.9	-65.4	-26.3

Fixed Income (returns)	Yield	MTD	YTD	1 yr	2 yr
U.S. Aggregate	3.22%	-0.2%	0.9%	3.4%	4.3%
U.S. Invest Grade Corp	3.94%	0.1%	2.4%	2.8%	5.8%
U.S. High Yield Corp	6.78%	0.7%	5.2%	4.3%	8.4%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	97.0480	1.5%	0.9%	8.9%	-4.2%
CAD/USD	0.7522	-1.3%	2.6%	-6.0%	-1.7%
USD/CAD	1.3295	1.3%	-2.5%	6.4%	1.7%
EUR/USD	1.1292	-1.4%	-1.5%	-9.3%	6.7%
GBP/USD	1.2796	-2.4%	0.3%	-8.6%	2.6%
AUD/USD	0.7101	-2.4%	0.7%	-10.4%	-7.3%
USD/JPY	110.5300	1.5%	0.8%	3.3%	-3.3%
EUR/JPY	124.8100	0.1%	-0.8%	-6.3%	3.3%
EUR/GBP	0.8825	1.1%	-1.8%	-0.8%	4.0%
EUR/CHF	1.1353	-0.2%	0.9%	-1.9%	6.7%
USD/SGD	1.3580	0.9%	-0.4%	3.3%	-4.4%
USD/CNY	6.7720	1.1%	-1.5%	6.8%	-1.4%
USD/MXN	19.2592	0.8%	-2.0%	3.7%	-4.9%
USD/BRL	3.7188	2.0%	-4.0%	15.3%	20.6%

Source - Bloomberg. Note: Equity returns do not include dividends, except for the 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 9:35 pm GMT 2/14/19.

Examples of how to interpret currency data: CAD/USD 0.75 means 1 Canadian dollar will buy 0.75 U.S. dollar. CAD/USD 2.6% return means the Canadian dollar rose 2.6% vs. the U.S. dollar year to date. USD/JPY 110.53 means 1 U.S. dollar will buy 110.53 yen. USD/JPY 0.8% return means the U.S. dollar rose 0.8% vs. the yen year to date.

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Hold [Sector Perform]	642	40.25	111	17.29
Sell [Underperform]	77	4.83	7	9.09

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