Market brief

RBC Wealth Management Dominion Securities

Much ado about the tariff tantrum

In case you haven't been following U.S. President Donald Trump's twitter handle of late, as of May 10, trade negotiations between the U.S. and China deteriorated further with the U.S. raising tariffs to 25% on $200B of Chinese imports from 10%. In addition to this, the U.S. government issued a new threat of a 25% tariff on an additional $325B of Chinese goods, targeting an array of items from clothing to toys and electronics. Not to be outdone, on the morning of May 13, China upped the ante by announcing it will raise tariffs on $60B of U.S. goods in retaliation. Beijing will increase tariffs by up to 25% on more than 5,000 products. Duties on some other goods will increase to 20% (from 5% or 10%).

We think the recent trade impasse will continue to rattle markets, with the S&P 500 down about 4% since May 3, while, more recently, volatility awakened from what seemed to be a more dormant state. Though one could argue that even prior to the recent escalation in the U.S.-China trade war, the U.S. market was already stretched given the S&P 500 had scratched new highs and the P/E had re-rated back to October 2018 levels—the highs achieved right before the correction.

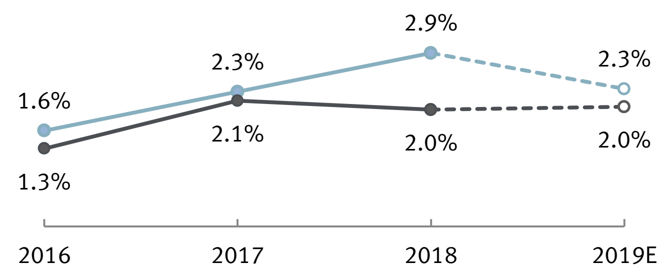
Yet, the more concerning and complex issue is whether or not the re-emergence of economic uncertainty related to the U.S.-China trade war signals the standard breather in the market—the likes of which we have seen many a time during this cycle—or a prolonged leg lower. We acknowledge that valuations could be under pressure in the short-to-medium term. However, we do not believe this latest iteration of the U.S.-China trade war in and of itself is sufficient to warrant a prolonged period of selling in the market, or induce a U.S. recession.

It's worth noting that U.S. GDP growth has been largely resilient to the trade war (initiated by the U.S. in January 2018), while consumer prices have been mostly immune. On the latter point, there is risk of inflation pressuring higher with the recent trade-war escalation, though this could simply be a short-term bump, as it's debatable whether inflation will structurally move higher.

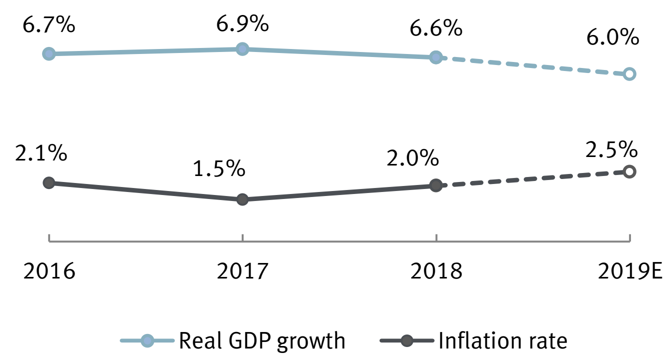
In terms of the future impact to GDP growth, RBC Capital Markets estimates that a full slate of tariffs (or an all-out trade war between the U.S. and China) would shave about 0.5% off U.S. real GDP growth—not an insignificant figure by any stretch, though insufficient to induce a recession at current levels of GDP growth for the U.S. economy. Even if one were to double this estimate of loss of GDP, U.S. economic growth would still be positive based on our real GDP growth estimate of 2.3% in 2019 (see the first chart).

U.S.-China economic outlook

U.S. GDP and inflation estimates



China GDP and inflation estimates

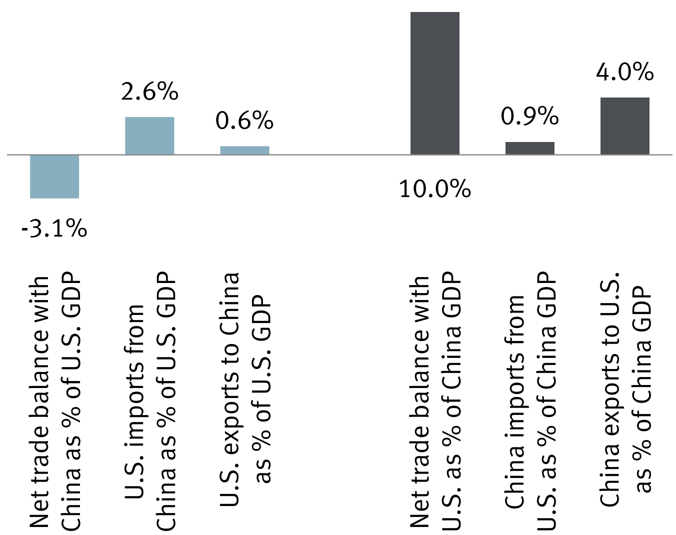


Source - RBC Investment Strategy Committee, RBC Capital Markets, Global Portfolio Advisory Committee, RBC Global Asset Management; data through 4/29/19

By the same token, to the extent that a trade war between the U.S. and China metastasizes into an all-out global trade war, we believe this would pull forward the risk of a recession, not only in the U.S. but worldwide. Yet we note that thus far global protectionist inclinations remain largely restrained outside of the U.S.-China trade dispute. Even in such a scenario, we would underscore that the U.S., which is a consumption-

For important disclosures and author's contact information see page 3.

U.S.-China trade as a % of GDP (2018)



Source - Bureau of Economic Analysis, Census Bureau, China National Bureau Statistics

based economy, remains in a position of strength relative to other developed nations where GDP has been growing at a slower pace, and also (we would opine) relative to China which has a greater reliance on trade as illustrated in the top left chart.

Though negotiations ended on May 10 with no deal in sight, Trump and China President Xi Jinping will be in Japan at the end of June for the G20 Summit, where we may see some progress. Longer term, we believe it is in both countries' interest to reach an agreement as the two stand to lose from a trade war. As established above, China stands to lose disproportionately given its greater reliance on trade relative to the U.S. Yet, heading into the 2020 U.S. election we think Trump will need to weigh the political risks posed by the failure of striking a deal with higher consumer prices coupled with continued volatility in the stock market.

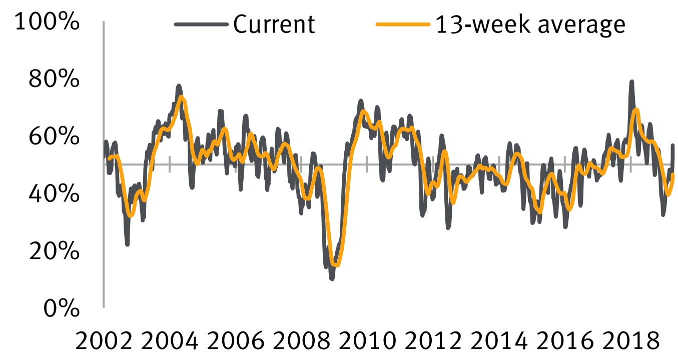
Finally, and perhaps most importantly, our focus remains on the fundamentals: positive EPS revisions for 2019, robust employment (see top right charts), and supportive financial conditions.

In addition, the set of economic indicators we track for early warnings signs of a recession, as shown in the table at the bottom of the page, strongly suggest U.S. economic growth is on solid footing through the course of the next year. While any of these could deteriorate from here on out, our guess is that this will not happen overnight, and not all at the same time. As such, investors will still have time to reposition portfolios more defensively, if they have not done so already.

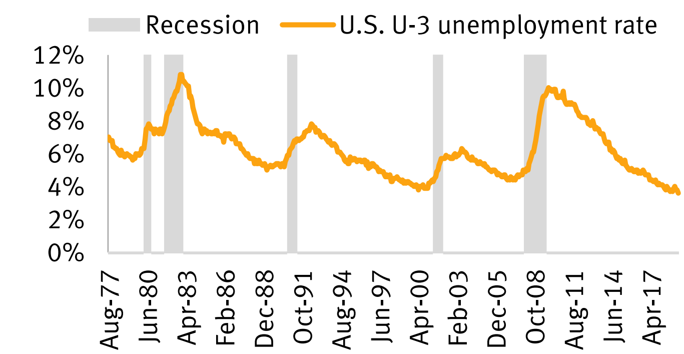
In the meantime, we continue to advocate for Market Weight exposure in equities, and would use recent pullbacks to opportunistically move up the quality curve with respect to

Fundamentals in focus

S&P 500 Index: Upward EPS estimate revisions



U.S. unemployment rate & recessions



Source - RBC U.S. Equity Strategy; S&P Capital IQ/Clarifi; CIQ Estimates; Bloomberg; S&P 500 data through 5/5/19 and unemployment data through 4/30/19

U.S. stocks that have hitherto screened richly. Our bias is towards companies with established leadership (preferably in secular growth areas), a track record of execution even during periods of economic uncertainty, relatively clean balance sheets, and those that are preferably dividend-oriented or have a higher portion of recurring revenues. These attributes combined, we believe, ultimately provide a source of ballast to stock performance and should reduce overall volatility in portfolios.

RBC Wealth Management U.S. economic indicator scorecard

Indicator	Status		
Yield Curve (12-month to 10-year)	–	✓	–
Unemployment Claims	✓	–	–
Unemployment Rate	✓	–	–
Conference Board Leading Index	✓	–	–
ISM New Orders Minus Inventories	✓	–	–
Fed Funds vs. Nominal GDP Growth	✓	–	–

Expansion	Neutral	Recessionary

Source - RBC Wealth Management, Bloomberg, FRED Economic Data St. Louis Fed

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