

Asset Allocation Strategy

CIO Office | April 2024

Job done?

Highlights

- As in 2023, the first quarter of 2024 turned out positively for stock markets, especially in the U.S., as the Fed maintained its rate-cutting intentions despite higher growth and inflation prospects. Does this mean the Fed's job is done?
- Historically, the start of a rate cut-cycle is a sign that an economic slowdown is upon us, not behind us. However, if there are signs that pressures on employment are intensifying, we may have to wait until late 2024/early 2025 to see the situation deteriorate more significantly.
- Remarkably, while Canada's inflation and economy are weaker than in the U.S., one might be inclined to believe the opposite by listening to the latest communications from the two central banks. Sooner or later, the Bank of Canada will have no choice but to adjust its message in turn, which could see the Loonie weaken.
- In sum, while expectations for the stock market are already very high, recent years have demonstrated the enormous influence the Fed can have on market direction and the Central Bank's current posture sends out a strong dovish signal.
- As such, although our base-case scenario still calls for a slowdown in inflation combined with greater economic turbulence over a 12-month horizon, the Fed's assertive pivot led us to upgrade equities against bonds for the third time in four months on March 26, this time bringing their respective allocations to neutral. Geographically, we remain aligned with our relative momentum model, having successfully captured the outperformance of U.S. equities, especially in relation to Emerging Markets, which we have been underweighting since late August 2022.

Table 1 Global Asset Allocation Views

	-	←	=	→	+	Δ
Asset Classes						
Cash						
Fixed Income						↓
Equities						↑
Alternatives*						
Fixed Income						
Government						
Investment Grade						
High Yield						
Duration						
Equities						
Canada						
United States						
EAFE						
Emerging Markets						
Value (vs. Growth)						
Small (vs. Large)						
Cyclicals (vs. Defensives)						
Alternatives & FX						
Inflation Protection						
Gold						
Non-Traditional FI						
Uncorrelated Strategies						
Canadian Dollar						↓

This table is for illustration purposes only. Bars represent the degree of preference of an asset relative to the maximum deviation allowed from a reference index. The further to the right (left) they are, the more bullish (bearish) our outlook for the asset is. No bars indicate a neutral view. The column under the delta sign (Δ) displays when our outlook has improved (↑) or worsened (↓) from the previous month. Consult Table 3 to see how they translate into a model balanced portfolio. *For tactical portfolios featuring alternative assets, the position is financed 1/3 by equities and 2/3 by bonds.

CIO Office

Market Review

Fixed Income

- While the confirmation of the Fed's rate-cutting intentions benefitted Bond markets in March, the asset class nonetheless ended the first quarter slightly down after starting the year with high expectations.
- Faced with a resilient economy, riskier segments such as Preferred Shares and High-Yield Bonds have outperformed over the past three months.

Equities

- Optimism continued to carry stock markets higher, with the S&P 500 recording a fifth consecutive month of gains as well as its best start to the year since 2019.
- In terms of leadership, while U.S. technology companies continued to do well in Q1-2024, gains were generally more broadly spread across sectors, with a special mention for the Energy sector, which benefitted from a rebound in oil. On the other hand, Emerging Markets continued to trail.

FX & Commodities

- Gold prices rallied strongly in March, supported by heavy buying by some central banks, a high degree of geopolitical uncertainty, and the approach of rate cuts.
- Although currencies remained fairly stable in March, the relative strength of the U.S. economy generally benefitted the Greenback in the first quarter, notably against the Canadian dollar, which ended the period down 2.2%.

Table 2 Market Total Returns

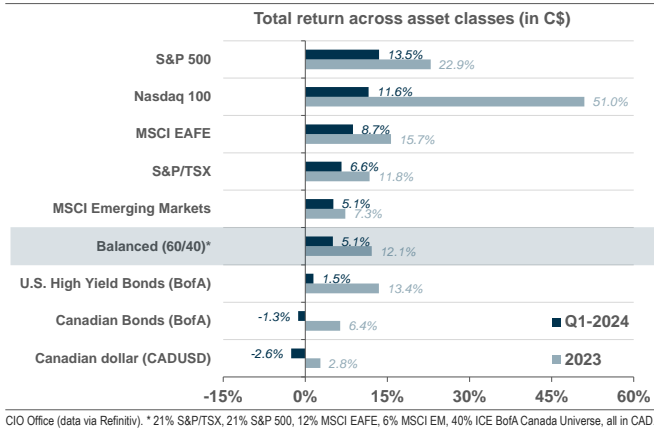
Asset Classes	March	Q1	2023
Cash (S&P Canada T-bill)	0.4%	1.2%	4.8%
Bonds (ICE BofA Canada Universe)	0.4%	-1.3%	6.4%
Short Term	0.5%	0.4%	4.9%
Mid Term	0.7%	-1.1%	5.7%
Long Term	0.1%	-3.9%	8.8%
Federal Government	0.5%	-1.1%	4.8%
Corporate	0.6%	0.1%	8.3%
S&P/TSX Preferred Shares	3.5%	9.6%	5.9%
U.S. Corporate (ICE BofA US\$)	1.2%	-0.1%	8.4%
U.S. High Yield (ICE BofA US\$)	1.2%	1.5%	13.4%
Canadian Equities (S&P/TSX)	4.1%	6.6%	11.8%
Communication Services	-6.6%	-8.5%	-3.9%
Consumer Discretionary	1.0%	4.5%	11.0%
Consumer Staples	-3.1%	4.0%	12.2%
Energy	7.3%	13.1%	6.3%
Financials	3.4%	5.5%	13.9%
Health Care	13.5%	18.4%	18.3%
Industrials	2.9%	11.1%	11.9%
Information Technology	-0.3%	4.8%	69.2%
Materials	15.4%	5.8%	-1.3%
Real Estate	2.3%	1.7%	6.9%
Utilities	2.6%	-1.1%	0.2%
S&P/TSX Small Caps	7.5%	7.9%	4.8%
U.S. Equities (S&P 500 US\$)	3.2%	10.6%	26.3%
Communication Services	4.3%	15.8%	55.8%
Consumer Discretionary	0.1%	5.0%	42.4%
Consumer Staples	3.5%	7.5%	0.5%
Energy	10.6%	13.7%	-1.3%
Financials	4.8%	12.5%	12.1%
Health Care	2.4%	8.9%	2.1%
Industrials	4.4%	11.0%	18.1%
Information Technology	2.0%	12.7%	57.8%
Materials	6.5%	8.9%	12.5%
Real Estate	1.8%	-0.5%	12.4%
Utilities	6.6%	4.6%	-7.1%
Russell 2000 (US\$)	3.6%	5.2%	16.9%
World Equities (MSCI ACWI US\$)	3.2%	8.3%	22.8%
MSCI EAFE (US\$)	3.4%	5.9%	18.9%
MSCI Emerging Markets (US\$)	2.5%	2.4%	10.3%
Commodities (GSCI US\$)	4.7%	10.4%	-4.3%
WTI Oil (US\$/barrel)	6.0%	16.8%	-10.4%
Gold (US\$/oz)	8.3%	7.2%	13.8%
Copper (US\$/tonne)	4.3%	3.6%	1.2%
Forex (US\$ Index DXY)	0.4%	3.2%	-2.7%
USD per EUR	-0.2%	-2.2%	3.5%
CAD per USD	-0.3%	2.2%	-2.2%

CIO Office (data via Refinitiv, as of 2024-03-29)

Hope for the best

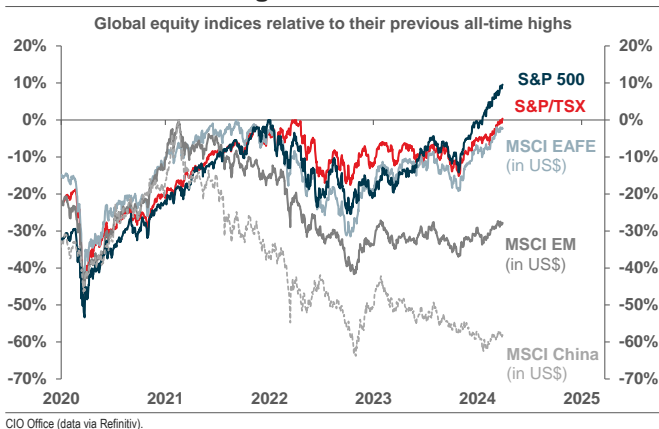
As in 2023, the first quarter of 2024 turned out positively for stock markets, particularly in the U.S., except that the rise was no longer as concentrated in technology companies – the S&P 500 even outperformed the Nasdaq 100 over the period – while bonds came under more pressure (**Chart 1**).

1 | A buoyant first quarter for equities...



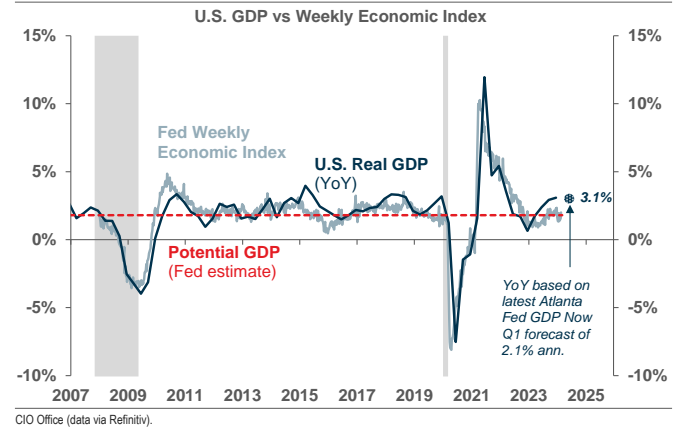
Thus, not only the S&P 500, but even the S&P/TSX have set new all-time highs, while the EAFE region is not far off the mark (in US\$). Only Emerging Markets lagged behind, held back in part by China's woes, despite a rise in Q1-2024 (**Chart 2**).

2 | ... with record highs in North America



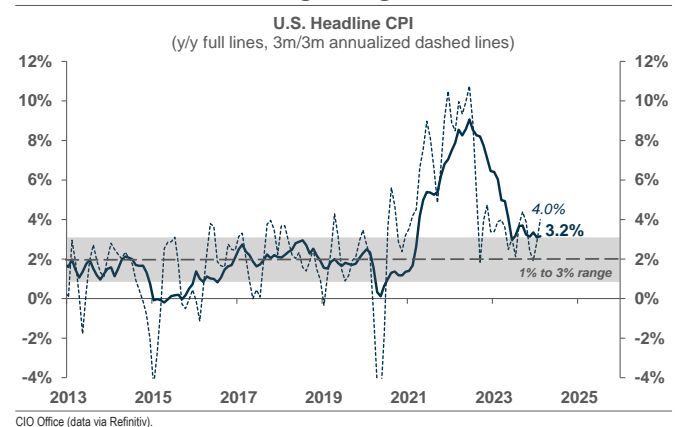
Three key factors underpin these market movements. First: the resilience of the U.S. economy (**Chart 3**), feeding optimism regarding the outlook for corporate earnings growth.

3 | Resilient economic growth...

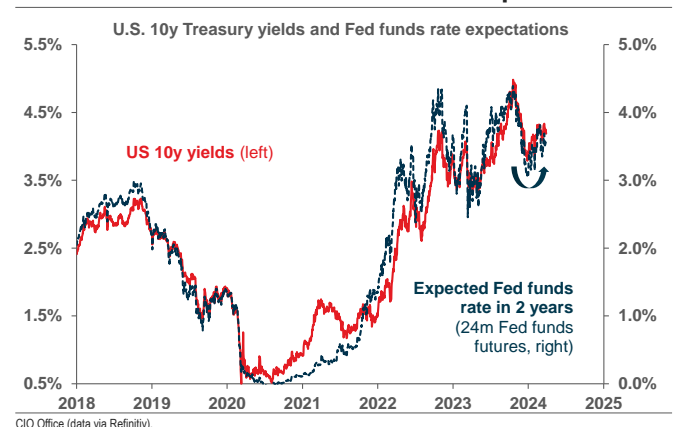


Second: the recent acceleration in inflation in the United States, leading the annual variation to stagnate above 3% (**Chart 4**) and prompting markets to lower their expectations of monetary easing (**Chart 5**).

4 | ... and inflation stagnating near 3%...

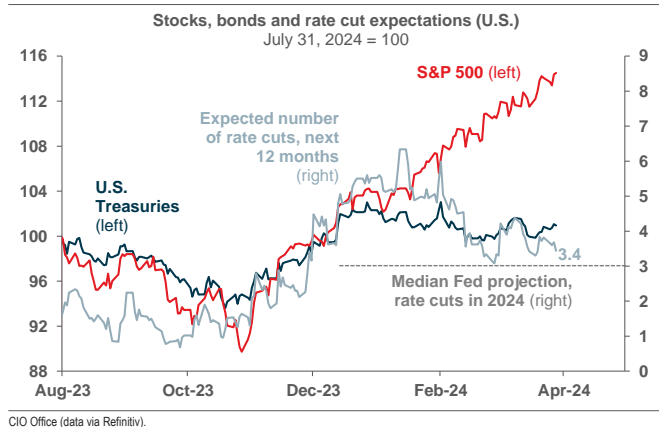


5 | ... forces markets to review their expectations...



And third: despite prospects for higher growth and inflation, the Fed maintained its intention of three rate cuts in 2024. This effectively lowered the bar for rate cuts this year, opening the door to the stock market rally (**Chart 6**).

6 | ... to align with a Fed committed to cut



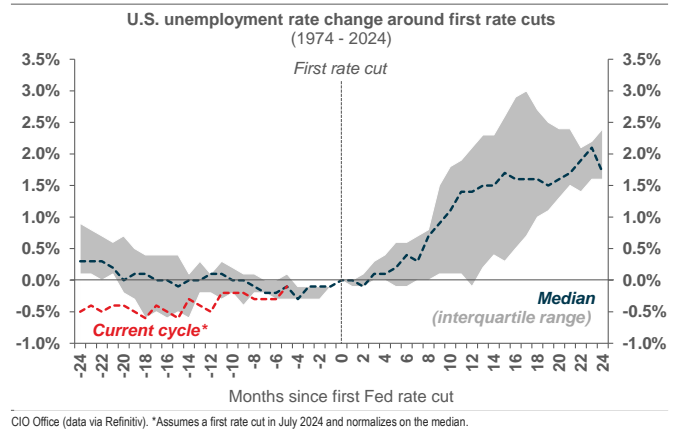
This backdrop is definitely a source of hope in the near term. But, does the approach of a first rate cut mean that the Fed's job is done? And, what about Canada?

Job done?

Historically, the start of a rate cut-cycle is a sign that an economic slowdown is upon us, not behind us. Indeed, while the unemployment rate is generally stable roughly three months around a first rate cut, the situation tends to worsen six to twelve months later. Assuming that the Fed will cut its benchmark rate for the first time in June or July, this implies we may have to wait until late 2024/early 2025 to see employment deteriorate more significantly (**Chart 7**).

Now, the fact of the matter is that unemployment has already started to rise, while there are signs that pressures on the job market are intensifying. For instance, the latest NFIB surveys suggest that companies' number one problem is gradually starting to migrate from labour to sales (**Chart 8**). Generally speaking, poor sales is synonymous with layoffs (**Chart 9**).

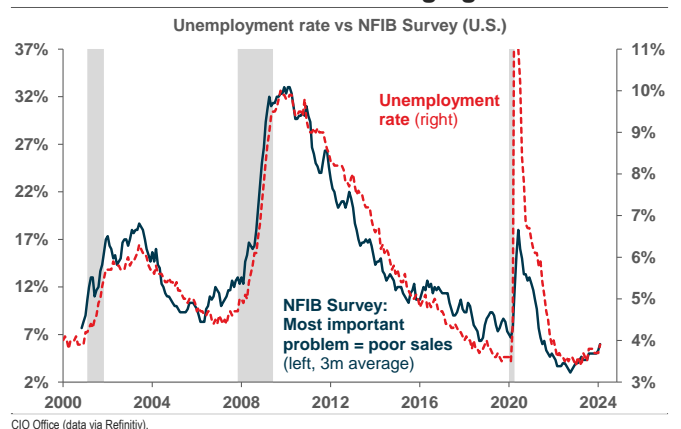
7 | The job market remains at risk



8 | Labour is less of a concern for businesses...

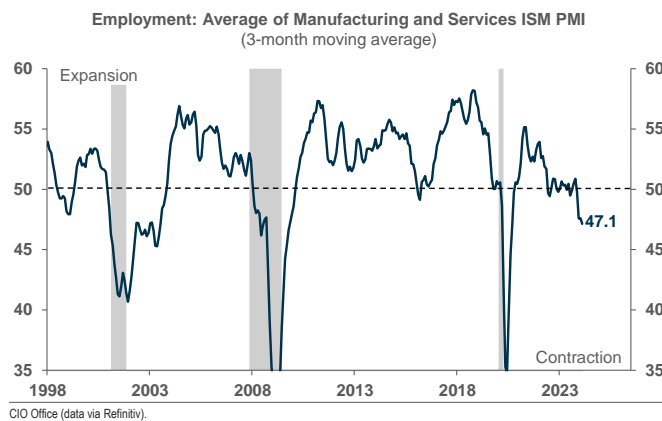


9 | ... as sales look more challenging



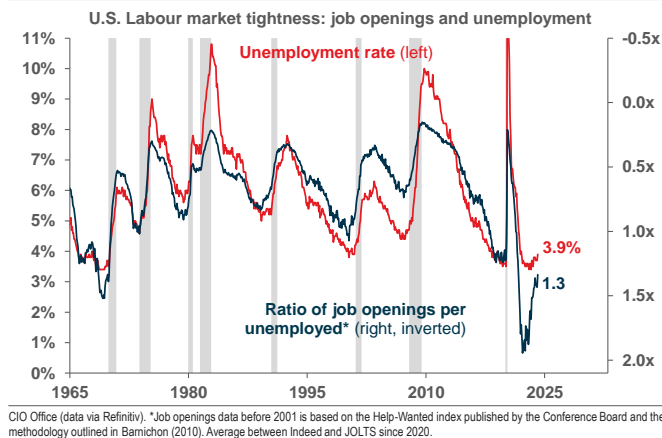
What's more, after remaining on the border over the past year, the average of the "employment" components of the Manufacturing and Services PMI Indices recently dipped into contraction territory (**Chart 10**, next page).

10 | A slowdown is clearly underway...



However, if this context is challenging for some workers, it is still not fundamentally problematic from a macroeconomic point of view, as the unemployment rate remains among the lowest of the last 60 years. What's more, although job openings are declining, the trend remains very gradual, as there are still around 30% more jobs to be filled than jobseekers (Chart 11).

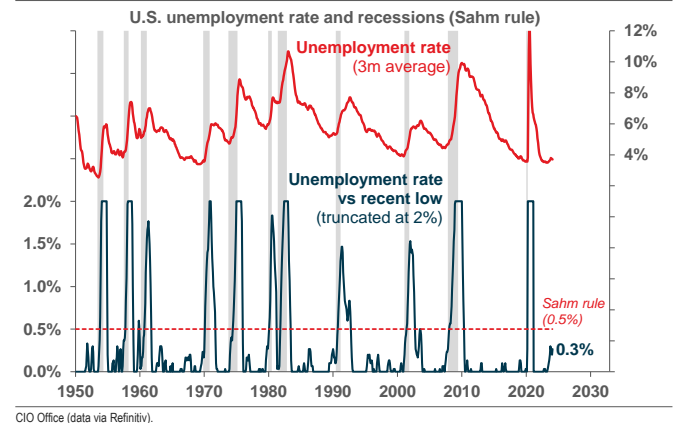
11 | ... but the situation is not problematic...



The big question, then, is when (and if) the job market will become problematic in the eyes of markets? No one knows for sure, but Sahm's rule¹ could serve as a useful reference point. For now, the rise in the average unemployment rate from last year's low remains below the 0.5% mark that has

signalled the start of every U.S. recession since 1950. However, a move closer to this threshold could definitely challenge the ongoing narrative (Chart 12).

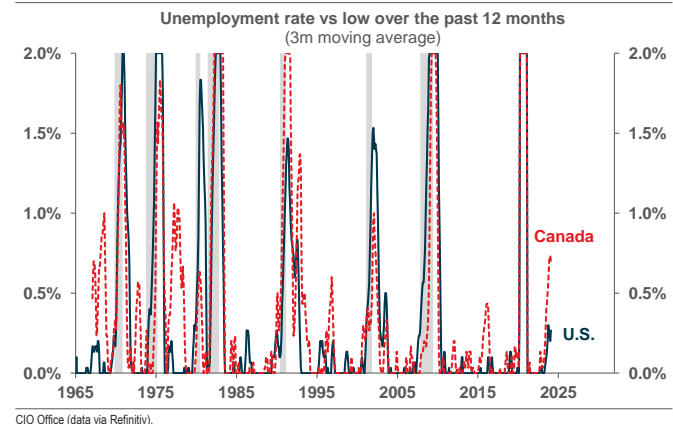
12 | ... for now ?



O Canada

If employment data are generally more volatile than that of our neighbours to the south, the relative weakness of our economy is becoming increasingly apparent (Chart 13).

13 | Canada's economy looks more fragile...

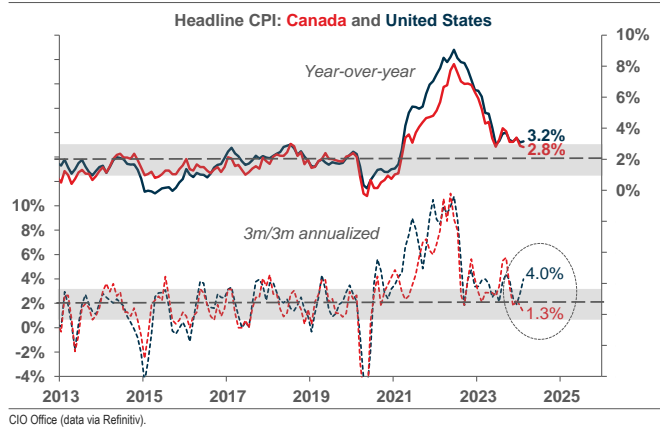


A divergence can also be seen in the most recent inflation figures, with CPI growth over the past three

¹ Developed by economist Claudia Sahm, the Sahm Rule observes whether the 3-month moving average of the U.S. unemployment rate has risen by 0.5% from its trough over the past 12 months. Since 1950, every time this has happened, the US economy has fallen into recession. Note that we have previously used a version based on a threshold of 0.33%, as this version has worked since 1970. Following revisions to employment data, the rise in average unemployment no longer crossed this threshold, reaching instead a maximum of 0.30%.

months of just 1.3% in Canada, versus 4.0% in the U.S. (annualized, **Chart 14**).

14 | ... with inflation seriously softening...

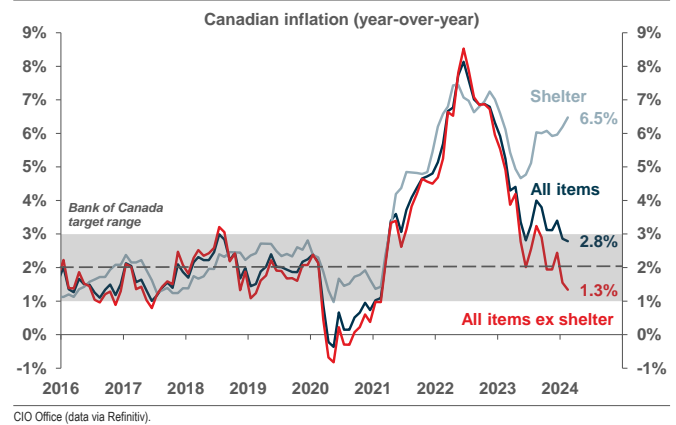


Fundamentally, the big difference between U.S. and Canadian inflation lies in housing, which remains highly problematic in this country, partly because this category includes mortgage interest costs, but also for reasons that the Bank of Canada (BoC) does not fully control.² To some extent, if the BoC wants to achieve its inflation target of between 1% and 3%, the rest of inflation must compensate for the sustained growth in housing prices. Now, we're certainly getting close to this with total CPI (2.8%) in the upper zone of the target range, and in the lower zone if housing is excluded (1.3%) (**Chart 15**).

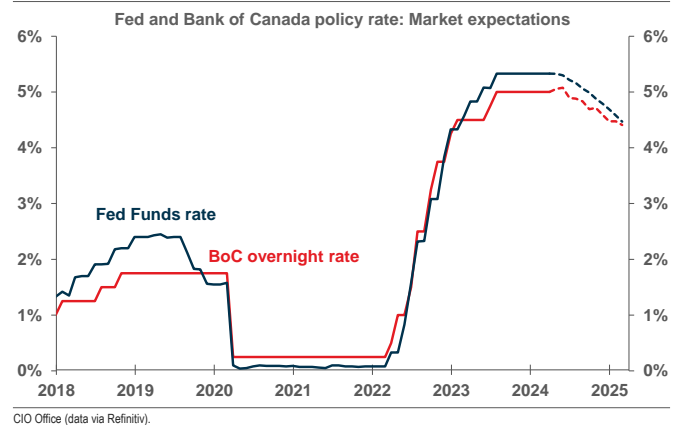
Remarkably, while Canada's inflation and economy are weaker than in the U.S., one might be inclined to believe the opposite by listening to the latest communications from the two central banks. As a result, markets are expecting essentially the same number of rate cuts on both sides of the border in 2024 (**Chart 16**).

To be continued, but sooner or later the Bank of Canada will have no choice but to adjust its message in turn, especially if the economy continues to weaken. For the Loonie, this context could see the currency falter and possibly even break out of its narrow trading range of the past two years (**Chart 17**).

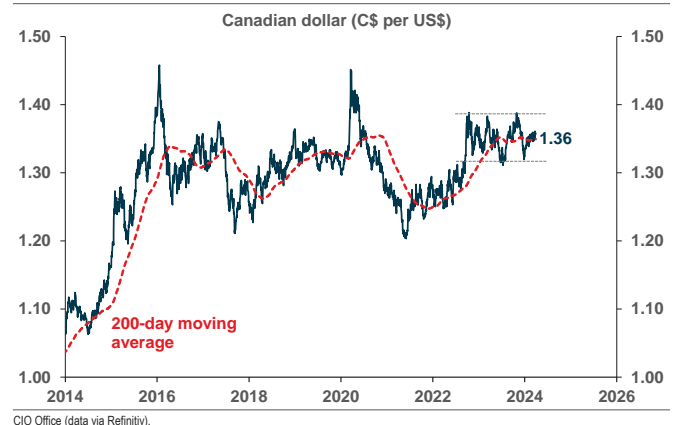
15 | ... practically everywhere except in housing



16 | A possible divide between the Fed and the BoC...



17 | ... could see the Canadian dollar weaken

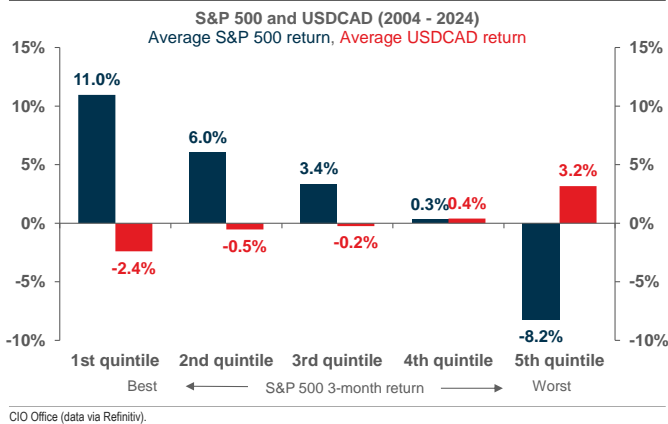


And, in all cases, greater exposure to the U.S. dollar ensures a degree of defensive bias, while still participating in the stock market, as the

² For more details, see NBF Economics & Strategy's [latest report on Canadian inflation](#) and special report: [Canada is caught in a population trap](#).

Greenback's defensive reputation against the Canadian dollar is well established (**Chart 18**).

18 | The Loonie is used to flying against the wind



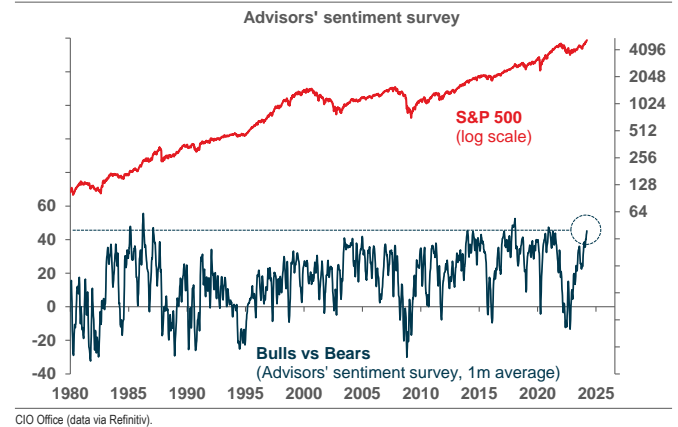
Bottom Line

Optimism abounds – the percentage of bullish versus bearish advisors has rarely been so high over the past forty years (**Chart 19**) – which shows that expectations for the stock market are already very elevated. As a result, markets could ultimately be caught short, with history suggesting that recession risks remain significant on a one-year horizon.

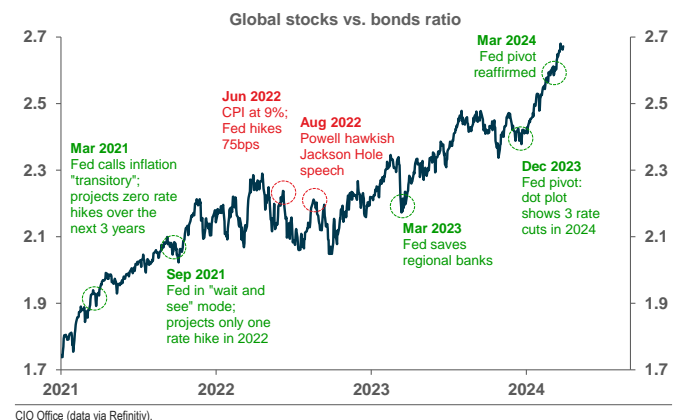
However, the last few years have demonstrated the enormous influence the Fed can have on market direction, with periods characterized by "hawkish" posture keeping markets on a downtrend in 2022, while a more "dovish" bias has ensured the continuation of the uptrend in 2021, 2023 and early 2024 (**Chart 20**).

In this respect, the fact that the Fed is considering rate cuts despite resilient growth and above-target inflation sends out a strong "dovish" signal, with three key potential implications for markets in the short term. On the one hand, a first cut as early as June or July has the potential to see stock market optimism persist for a few more months, assuming the economy continues to cooperate. On the other hand, the Fed suggests it will not hesitate to act swiftly – as happened a year ago during the regional bank debacle – in the event of significant

19 | Optimism abounds on stock markets...



20 | ... but the Fed's impact cannot be underestimated

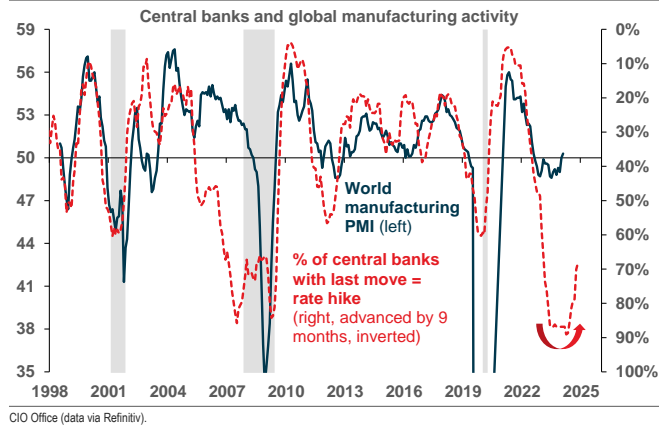


deterioration in economic activity, thereby reducing the risk of a financial accident. Finally, to a lesser extent but still worth considering, the apparent tolerance of inflation stagnating around 3% increases the chances of the Fed being surprised by rising inflation again (including of financial assets), which is a risk for bonds.

What's more, while several central banks (e.g. Switzerland, Brazil, China) have already begun cutting rates, a synchronized change of course by a majority of central banks could lead to a more significant recovery in global manufacturing activity (**Chart 21**, next page).

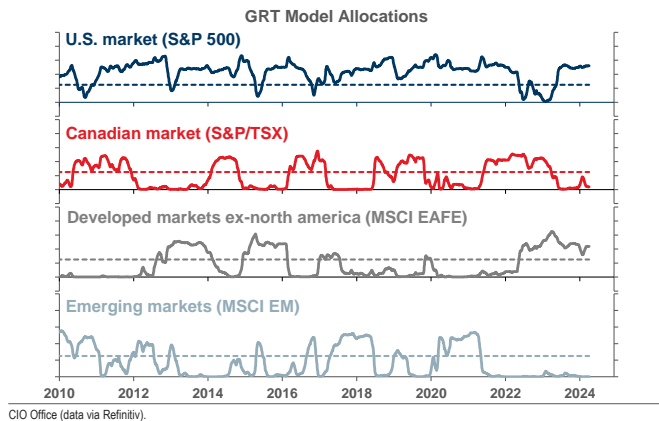
In sum, although our base-case scenario still calls for a slowdown in inflation combined with greater economic turbulence over a 12-month horizon, the Fed's assertive pivot led us to upgrade equities against bonds for the third time in four months on

21 | A global synchronized change of course in sight?



March 26, this time bringing their respective allocations to neutral. Geographically, we remain aligned with our relative momentum model, having successfully captured the outperformance of U.S. equities, especially in relation to Emerging Markets, which we have been underweighting since late August 2022 (**Chart 22**).

22 | Persistent trends across equity regions



Finally, an acknowledgement by the Bank of Canada of the more flagrant weakness of both our economy and inflation on our side of the border has the potential to see the Loonie retreat. In this regard, our economists expect a gradual depreciation of the currency to C\$1.43 per US\$ by the end of the year.³

³ Forex, NBF Economics and Strategy, March 12, 2024.

Table 3 Global Asset Allocation - Model Portfolio Weights (in CAD)

	Benchmark		Model Portfolio				Comments
	Total	Asset Class	Total		Asset Class		
			Allocation	Active Weight	Allocation	Active Weight	
Asset Classes							
Cash	0%	-	0.0%	0.0%	-	-	While recession risks remain high over a one-year horizon, the Fed's pivot could continue to support equity markets in the short term. Overall, this context argues for a balanced strategy across asset classes. Alternatives allow for better control of the total risk of the portfolio through their diversification effects.
Fixed Income	40%	-	38.0%	-2.0%	-	-	
Equities	60%	-	59.0%	-1.0%	-	-	
Alternatives	0%	-	3.0%	3.0%	-	-	
Fixed Income							
Government	29%	74%	28.3%	-1.1%	75%	0.9%	With lower inflation and rate cuts approaching, long-term yields are likely to decline, especially if the economic slowdown becomes more pronounced. This environment justifies a slightly longer duration, with credit exposure close to the benchmark.
Investment Grade	11%	26%	9.7%	-0.9%	25%	-0.9%	
High Yield	0%	0%	0.0%	0.0%	0%	0.0%	
Duration	7.1 yrs	-	8.1 yrs	1.0 yrs	-	-	
Equities							
Canada	21%	35%	19.0%	-2.0%	32%	-2.8%	Macro conditions are undermining the outlook for emerging markets and Canada (more cyclical), compared with the U.S. and EAFE (more defensive). In Canada, the low-volatility factor reduces the cyclical exposure of the S&P/TSX. In the U.S., high-quality, dividend-paying companies are less at risk in a recessionary environment, as are Japanese equities (in yen).
United States	21%	35%	24.0%	3.0%	41%	5.7%	
EAFE	12%	20%	13.0%	1.0%	22%	2.0%	
Emerging markets	6%	10%	3.0%	-3.0%	5%	-4.9%	
Alternatives							
Inflation Protection	0%	0%	0.0%	0.0%	0%	0.0%	A systematic quantitative strategy that takes advantage of market trends while aiming for maximum decorrelation with equities and tight control of volatility (NALT) plays an important role as a diversifier, while offering exposure to high risk-free rates.
Gold	0%	0%	0.0%	0.0%	0%	0.0%	
Non-Traditional FI	0%	0%	0.0%	0.0%	0%	0.0%	
Uncorrelated Strategies	0%	0%	3.0%	3.0%	100%	100.0%	
Foreign Exchange							
Canadian Dollar	61%	-	57.0%	-4.0%	-	-	The overall portfolio strategy involves an overweight in the US dollar and the yen. This positioning reflects the geographic allocation within equities, as well as a willingness to underweight the Canadian dollar against safe-haven currencies in an uncertain global economic context, and a more challenging one in Canada.
U.S. Dollar	21%	-	27.0%	6.0%	-	-	
Euro	5%	-	3.8%	-0.8%	-	-	
Japanese Yen	3%	-	5.5%	2.5%	-	-	
British Pound	2%	-	1.4%	-0.3%	-	-	
Others	9%	-	5.3%	-3.5%	-	-	

CIO Office. The fixed income benchmark is 100% FTSE Canada Universe. There are no alternative assets in the benchmark as their inclusion is conditional on improving the risk/return properties of traditional assets (60/40). The amplitude of the colour bars under the "Active Weight" columns are proportional to the maximum deviations of the portfolio (+/- 10% for stocks and bonds, +10% in cash, +20% in alternative assets).

CIO Office
CIO-Office@nbc.ca

Martin Lefebvre
Chief Investment Officer
martin.lefebvre@nbc.ca

Louis Lajoie
Director
Investment Strategy
louis.lajoie@nbc.ca

Simon-Carl Dunberry
Director
Portfolio Strategy
simon-carl.dunberry@nbc.ca

Nicolas Charlton
Associate
Quantitative Strategy
nicolas.charlton@nbc.ca

Mikhael Deutsch-Heng
Associate
Investment Strategy
mikhael.deutschheng@nbc.ca

Zaid Shoufan
Associate
Portfolio Strategy
zaid.shoufan@nbc.ca

Julien Gordon
Analyst
Quantitative Strategy
julien.gordon@nbc.ca

General

The information and the data supplied in the present document, including those supplied by third parties, are considered accurate at the time of their printing and were obtained from sources which we considered reliable. We reserve the right to modify them without advance notice. This information and data are supplied as informative content only. No representation or guarantee, explicit or implicit, is made as for the exactness, the quality and the complete character of this information and these data. The opinions expressed are not to be construed as solicitation or offer to buy or sell shares mentioned herein and should not be considered as recommendations.

Views expressed regarding a particular company, security, industry, market sector, future events (such as market and economic conditions), company or security performance, upcoming product offerings or other projections are the views of only the CIO Office, as of the time expressed and do not necessarily represent the views of National Bank of Canada and its subsidiaries (the "Bank"). Any such views are subject to change at any time based upon markets and other conditions, which could cause actual results to differ materially from what the CIO Office presently anticipate(s) or project(s). The Bank disclaims any responsibility to update such views. These views are not a recommendation to buy or sell and may not be relied on as investment advice.

These index providers may be included in this document: BofA, Merrill Lynch, Standard & Poor's, FTSE, Nasdaq, Russel and MSCI. These companies are licensing their indices "as is," make no warranties regarding same, do not guarantee the suitability, quality, accuracy, timeliness and/or completeness of their indices or any data included in, related to or derived therefrom, assume no liability in connection with their use and do not sponsor, endorse or recommend National Bank of Canada and its wholly owned subsidiaries any of their products and services. The above index providers do not guarantee the accuracy of any index or blended benchmark model created by National Investment Bank using any of these indices. No responsibility or liability shall attach to any member of the Index Providers or their respective directors, officers, employees, partners or licensors for any errors or losses arising from the use of this publication or any information or data contained herein. In no event shall the above Index Providers be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, legal or other expenses, or losses (including, without limitation, lost revenues or profits and opportunity costs) arising out of or in connection with the use of the content, even if advised of the possibility of such damages.

The FTSE/TMX indices are trademarks of the LSE Group. S&P Indices are trademarks of S&P Dow Jones Indices LLC, a division of S&P Global. MSCI indices are trademarks of MSCI Inc. BofA indices are trademarks of Merrill Lynch, Pierce Fenner & Smith incorporated ("BofAML"). Nasdaq index is a trademark of Nasdaq Inc. Russell 2000 ® is a trademark of the Frank Russell Company.

© 2024 National Bank Investments Inc. All rights reserved. Any reproduction, in whole or in part, is strictly prohibited without the prior written consent of National Bank Investments Inc.

© NATIONAL BANK INVESTMENTS is a registered trademark of National Bank of Canada, used under licence by National Bank Investments Inc. National Bank Investments is a signatory of the United Nations-supported Principles for Responsible Investment, a member of Canada's Responsible Investment Association, and a founding participant in the Climate Engagement Canada initiative.