

Asset Allocation Strategy

CIO Office | February 2022

Acclimatization process underway

Highlights

- Stocks started the new year nervously, with the S&P 500 suffering its worst pullback since March 2020. At this point, this turnaround seems more reflective of an acclimatization process ahead of an impending tightening of monetary conditions than the beginning of a more serious bear market.
- With labour market conditions consistent with the Fed's maximum employment target and inflation at a multi-decade high, Powell essentially confirmed that the first rate hike will occur at the next policy meeting in March (as did Macklem in Canada).
- Looking back at the last 30 years, we find that stocks tend to react nervously at the onset of a rate-hike cycle – an acclimatization process visibly happening ahead of time given that the Fed is much more predictable nowadays. Beyond fluctuations, however, sustained earnings growth during the next 12 months should enable gains, as has been the case in each of the 5 historical episodes analyzed. Besides, 10-year yields tend to rise in the months before the first hike, but not so much thereafter, while the U.S. dollar generally peaks as the Fed hikes.
- In this context, we took advantage of the pullback to increase our equity allocation on January 28. The rapid rise in real yields and decline in stock valuations suggest that much of the upcoming monetary tightening is now discounted by markets. By the same token, in the absence of a pick-up in valuations that perhaps only a more dovish tone from the Federal Reserve could bring about, the rebound in equities is likely to be longer and less linear than what investors have been used to for almost 2 years. In any event, our market sentiment indicator is at its weakest since the March 2020 panic, an indication that downside potential is relatively limited at these levels.

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.

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Market Review

Fixed Income

- Canadian long-term yields surged in January, resulting in losses for bond holders. On the other hand, short-term debt and cash were among the month's best performing asset classes.
- The environment was just as challenging for U.S. fixed-income securities; both investment grade and high-yield bonds declined significantly.

Equities

- It's been a difficult start to the year for U.S. equities, with the S&P 500 falling below its 200-day moving average, and with both the Nasdaq Composite and the Russell 2000 closing the month in correction territory.
- The pullback in equities was most severe for higher-valued sectors such as consumer discretionary, information technology, and communication services. On the other hand, energy significantly outperformed on the back of surging oil prices.
- Meanwhile, Canada and emerging markets fared much better than the U.S., both supported by rising commodity prices and cheaper valuations.

FX & Commodities

- Oil prices have increased at a stellar pace since the beginning of the year. Public health restrictions are gradually being lifted around the world as Omicron fears further abate. At the same time, mounting geopolitical uncertainty surrounding the situation in Ukraine also contributed to rising energy prices.
- The USD shone in this environment, its role as a safe haven currency leading to a 0.6% gain to start the year.

Table 2 Market Total Returns

Asset Classes	January	12 MTH	2021
Cash (3-month T-bills)	0.0%	0.2%	0.2%
Bonds (FTSE CA Univ.)	-3.4%	-4.8%	-2.5%
FTSE CA Short term	-0.9%	-2.0%	-0.9%
FTSE CA Mid term	-2.7%	-4.8%	-2.7%
FTSE CA Long term	-6.9%	-8.3%	-4.5%
FTSE CA Government	-3.6%	-5.2%	-3.0%
FTSE CA Corporate	-2.9%	-3.7%	-1.3%
BoAML Inv. Grade (\$US)	-3.1%	-2.9%	-1.0%
BoAML High-Yield (\$US)	-2.7%	2.1%	5.4%
Preferred Shares	0.0%	16.3%	19.3%
CA Equities (S&P/TSX)	-0.4%	25.0%	25.1%
Energy	12.5%	63.0%	48.9%
Industrials	-2.9%	16.6%	16.5%
Financials	4.0%	42.1%	36.5%
Materials	-3.4%	4.1%	4.0%
Utilities	-2.2%	6.4%	11.6%
Cons. Disc	-2.0%	19.2%	18.4%
Cons. Staples	-2.7%	25.8%	22.4%
Healthcare	-9.1%	-46.0%	-19.6%
IT	-20.4%	-5.0%	18.5%
Comm. Svc.	1.6%	26.1%	24.7%
REITs	-5.7%	27.6%	37.4%
S&P/TSX Small Cap	-1.1%	18.4%	20.3%
US Equities (S&P500 USD)	-5.2%	23.3%	28.7%
Energy	19.1%	77.5%	54.6%
Industrials	-4.7%	20.6%	21.1%
Financials	0.1%	37.4%	35.0%
Materials	-6.8%	21.5%	27.3%
Utilities	-3.3%	14.9%	17.7%
Cons. Disc	-9.7%	11.9%	24.4%
Cons. Staples	-1.4%	23.4%	18.6%
Healthcare	-6.8%	16.0%	26.1%
IT	-6.9%	26.4%	34.5%
Comm. Svc.	-6.2%	15.5%	21.6%
REITs	-8.5%	33.1%	46.2%
Russell 2000 (USD)	-9.6%	-1.2%	14.8%
World Eq. (MSCI ACWI)	-4.9%	13.7%	19.0%
MSCI EAFE (USD)	-4.8%	7.5%	11.8%
MSCI EM (USD)	-1.9%	-6.9%	-2.2%
Commodities (CRB index)	9.8%	46.5%	38.5%
WTI Oil (US\$/barrel)	17.2%	68.9%	55.8%
Gold (US\$/ounce)	-1.4%	-3.3%	-4.0%
Copper (US\$/tonne)	-1.7%	21.8%	25.7%
Forex (DXY - USD index)	0.6%	6.6%	6.7%
USD per EUR	-1.4%	-7.7%	-7.1%
CAD per USD	0.6%	-0.6%	-0.8%

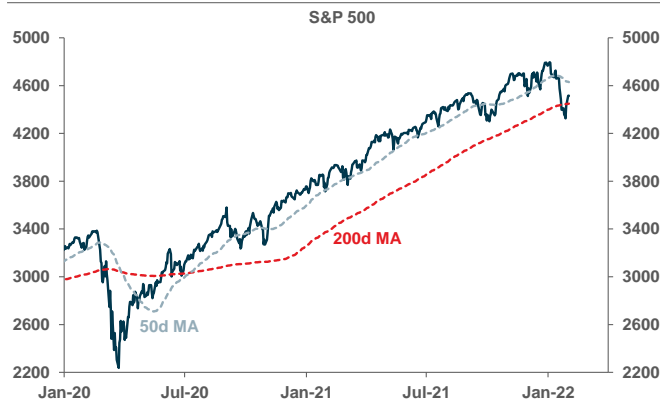
Data via Refinitiv

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A volatile start to the year

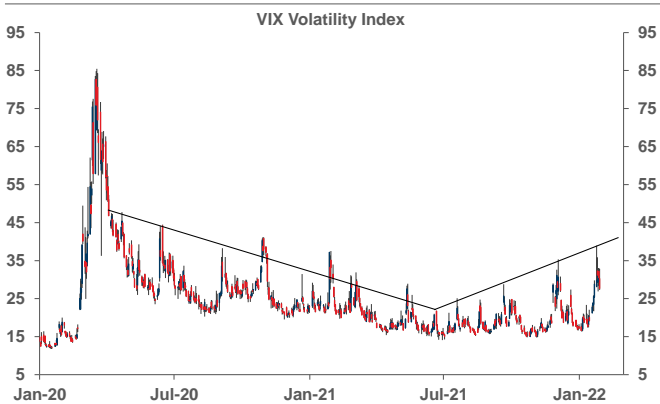
Equity markets started the new year nervously, with the S&P 500 breaking through its 200-day moving average for the first time since June 2020 (**Chart 1**). This was confirmed by the VIX (volatility index), on an uptrend from last summer's lows (**Chart 2**).

1 | A challenging start to the year for stocks...



CIO Office (data via Refinitiv).

2 | ... and a sustained rise in volatility

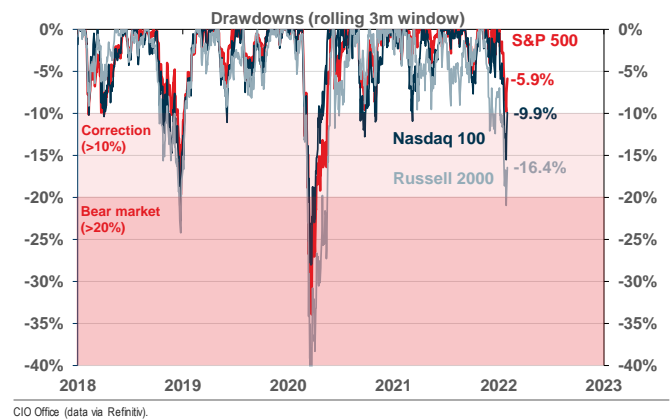


CIO Office (data via Refinitiv).

At the worst of the month, the U.S. flagship index stood just above the 10% correction threshold,¹ which was, however, crossed by more speculative areas of the market such as the tech-heavy Nasdaq 100 and the Russell 2000 small-cap index that even momentarily dipped into bear market territory (**Chart 3**).

Overall, January's portrait contrasts with Q4 2021 market action with, for instance, the majority of assets starting the year with losses (compared to

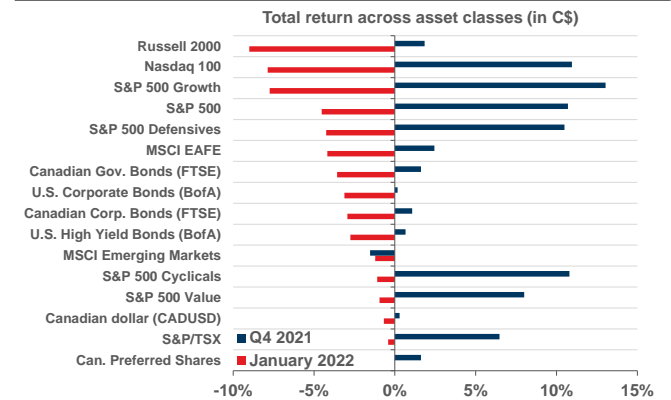
3 | Largest pullbacks since March 2020



CIO Office (data via Refinitiv).

widespread gains in Q4) and high-growth U.S. stocks (first in Q4) suffering more (**Chart 4**).

4 | January 2022 contrasts with Q4 2021



CIO Office (data via Refinitiv).

At this point, this sharp turnaround – likely accentuated by profit-taking after a year of strong gains – seems more reflective of an acclimatization process ahead of an impending tightening of monetary conditions than the beginning of a more serious bear market. To be sure, let's take stock of the economic and financial backdrop.

Jobs + inflation = rate hike in sight

It didn't take too long for the labour market to be characterized as consistent with the Fed's maximum employment goal, as mentioned in the most recent FOMC minutes. At 3.9%, the

¹ The S&P 500 crossed the correction threshold a few times in late January, but never at the close.

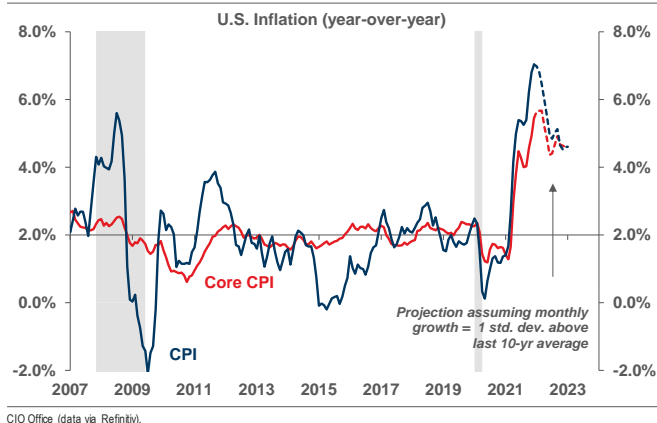
unemployment rate is now in the range sought by the U.S. Central Bank (**Chart 5**).

5 | The labour market is strong...



As for inflation, the majority of year-over-year measures remain at multi-decade highs. However, a peak is in the offing for this quarter, even in the very likely scenario where monthly price growth remains substantially higher than average (**Chart 6**).

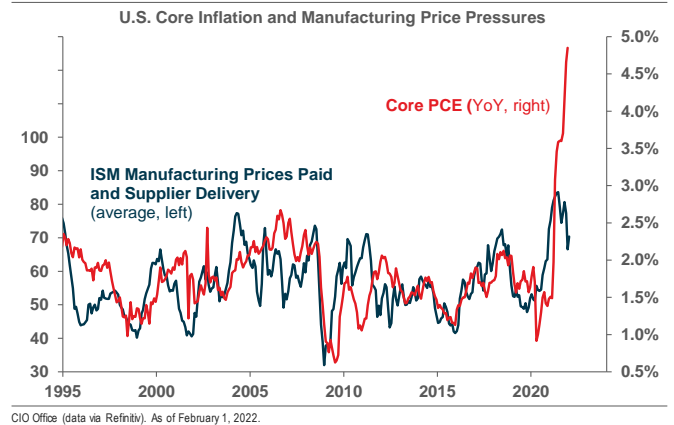
6 | ... and inflation should soon peak...



In addition, recent indicators of prices paid and delivery times in the manufacturing sector suggest that supply chain pressures are starting to ease, which should ultimately allow inflation to settle lower (**Chart 7**).

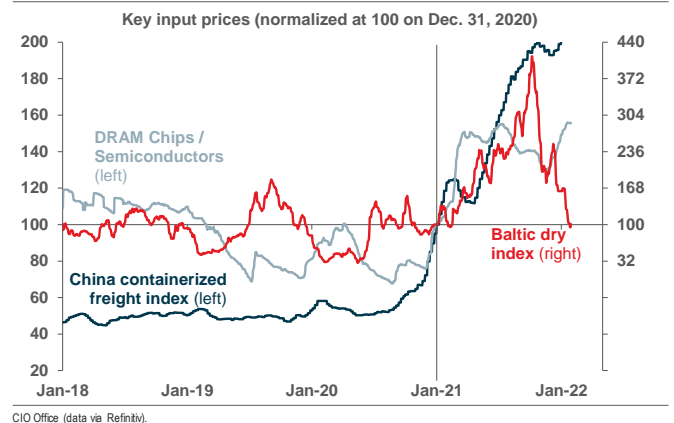
That said, other higher-frequency price indicators show we are still far from supply-demand equilibrium. Indeed, despite a sharp decline in

7 | ... with supply chain issues seemingly easing...



global bulk-shipping prices (Baltic Dry Index), the cost of shipping containers from China, as well as the price of semiconductors, have climbed back near their highs (**Chart 8**), a trend likely attributable to the impact the Omicron variant and ensuing restrictions have had on economic activity in Asia.

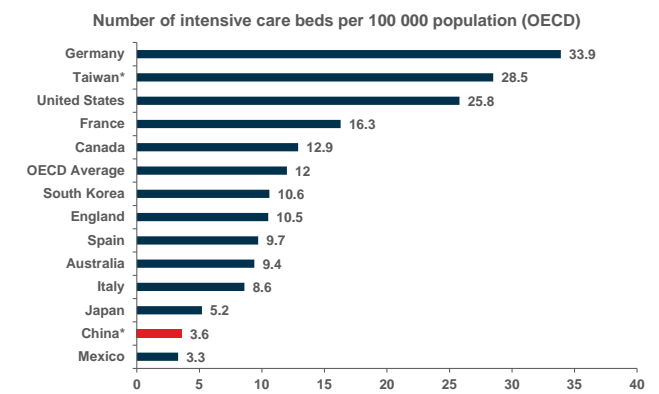
8 | ... although certainly not over



This illustrates how the pandemic remains a risk to global supply chains and inflation's normalization process. Indeed, even if an increasing number of countries are moving away from severe restrictions in their fight against the virus, this is not the case for China² (central to global supply chains) for which a lower number of intensive care beds per capita makes the strategy of letting the virus circulate much riskier (**Chart 9**, next page).

² Don't Expect China to Ease Its Zero-COVID Policy After the Beijing Olympics. Time, January 10, 2022

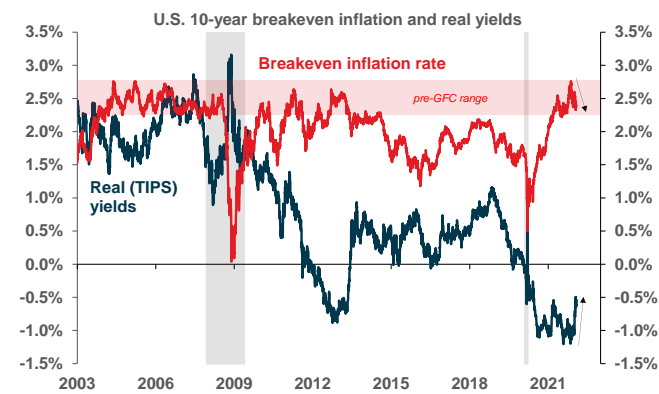
9 | Letting the virus spread is (more) risky for China



CIO Office (data via OECD). * Data for China and Taiwan from https://www.researchgate.net/publication/338520006_Critical_Care_Bed_Capacity_in_Asian_Countries_and_Regions

Notwithstanding this threat, recall that markets had already largely adjusted to the inflationary environment in 2021, leaving little room for upside surprises on this front. For instance, since the beginning of the year, measures of long-term inflation expectations have actually declined, while real yields have jumped by almost 50 bps (Chart 10).

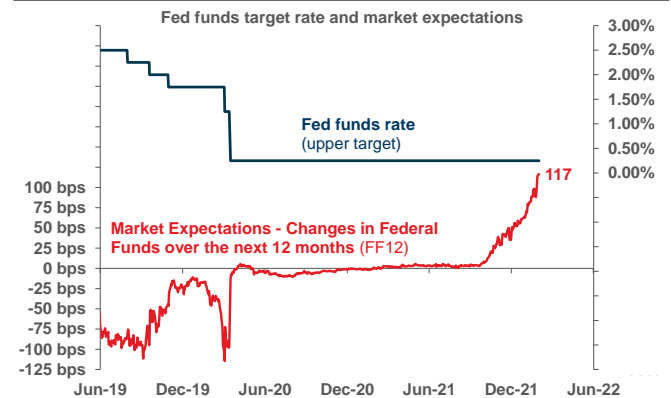
10 | Lower breakeven inflation, higher real yields...



CIO Office (data via Refinitiv).

As we discussed last December, such a move was to be anticipated amidst the beginning of the Fed's tightening of monetary conditions – sure to be the main theme of 2022. At the conclusion of its January 26 meeting, the Fed essentially confirmed that the first rate hike will occur at its next meeting on March 16, while Jerome Powell's comments pushed rate-hike expectations to nearly 5 over the coming 12 months (Chart 11).

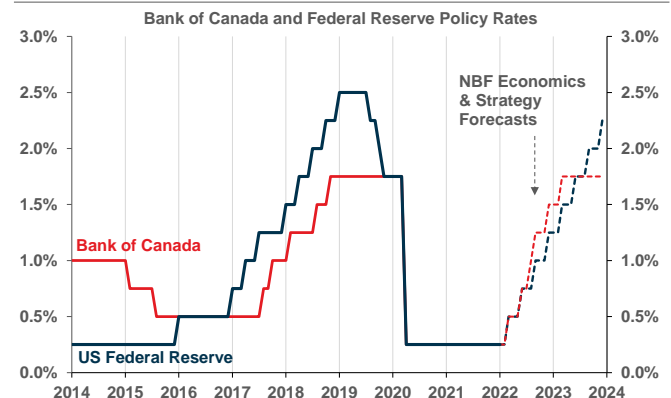
11 | ... with rate hikes straight ahead...



CIO Office (data via Bloomberg).

Our colleagues at NBF Economics & Strategy are now expecting the Fed to be a little more “nimble” with 4 hikes. Meanwhile, everything is aligned for a more prompt response by the Bank of Canada in 2022, with 5 hikes. Both central banks are expected to start hiking in March (Chart 12).

12 | ... for the Fed and the Bank of Canada



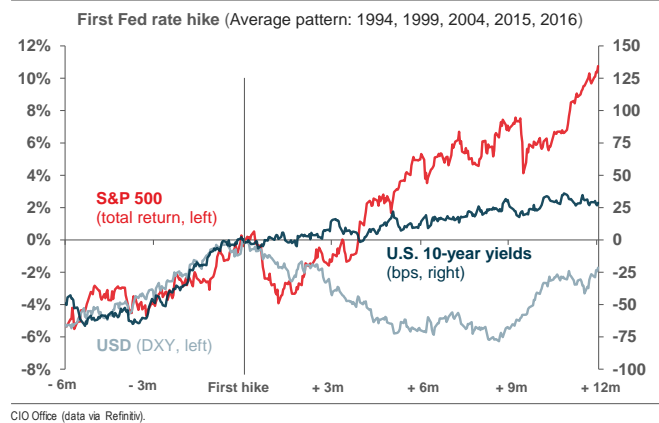
CIO Office (data via Refinitiv, NBF Economics & Strategy). Forecasts as of January 28, 2022.

Beginning of rate hikes = ?

Starting from the assumption that a new rate-hike cycle is around the corner, we have studied how different asset classes have performed in such circumstances over the last 30 years. The complete study is featured in a strategic report available

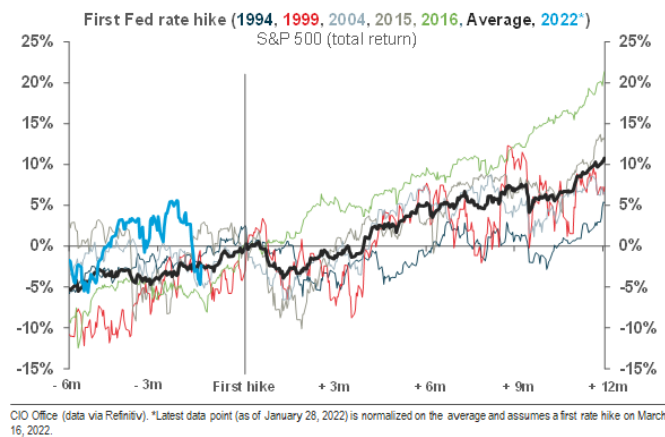
here.³ In short, we find that (1) the stock market tends to react nervously at the onset of a rate hike cycle, but these concerns quickly dissipate to give way to gains after 12 months, (2) 10-year yields tend to rise in the months before the first hike, but not so much thereafter, and (3) the U.S. dollar generally peaks as the Fed hikes, depreciating persistently in the following 6 months (**Chart 13**). Several parallels between these historical trends and the current environment can be drawn.

13 | What happens when the Fed starts to hike?



For the stock market, it seems that the acclimatization process involving increased volatility is happening ahead of time, not too shocking given the Fed is much more predictable nowadays (**Chart 14**).

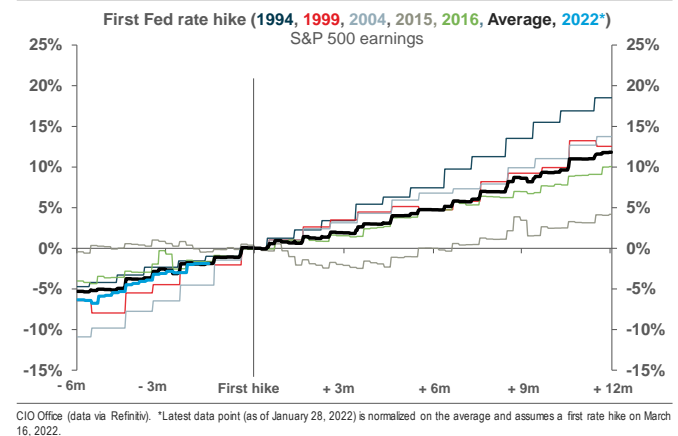
14 | S&P 500: initially volatile, ultimately positive...



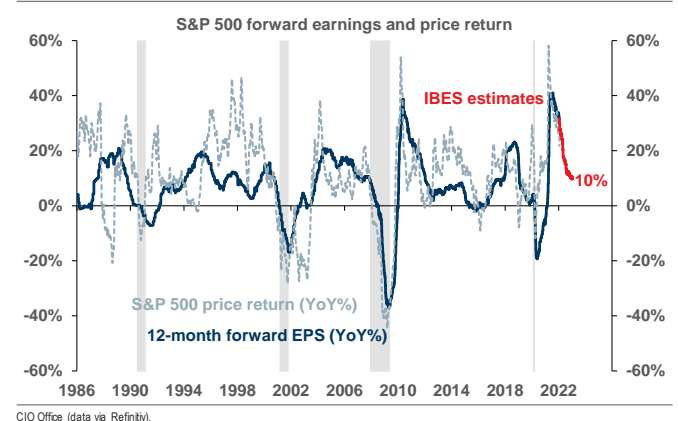
Beyond short-term fluctuations, however, sustained earnings growth during the next 12 months should

enable gains, as has been the case in each of the 5 historical episodes analyzed (**Chart 15**). At this juncture, the earnings outlook is for around 10% growth, in line with the historical average (**Chart 16**).

15 | ... thanks to steady earnings growth...



16 | ... as projected over the next 12 months

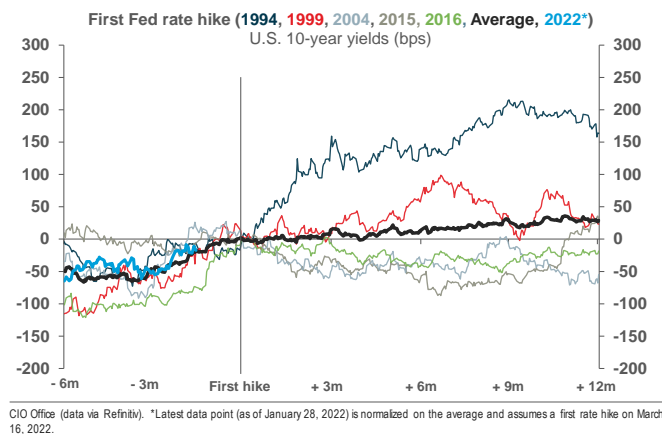


For 10-year Treasury yields, history suggests a ~30-bp upside potential by March, and little change thereafter. Naturally, the *flatish* historical average is all but a perfect forecast, considering the divergence between the upward trends of the 1990s and the downward trends during the 2000s (**Chart 17**, next page).

Nevertheless, it is roughly in line with the signal sent by the Fed's rate-hike expectations, which suggest a move up to the 2% threshold (likely once risk aversion subsides) and a maximum of 2.5% (as

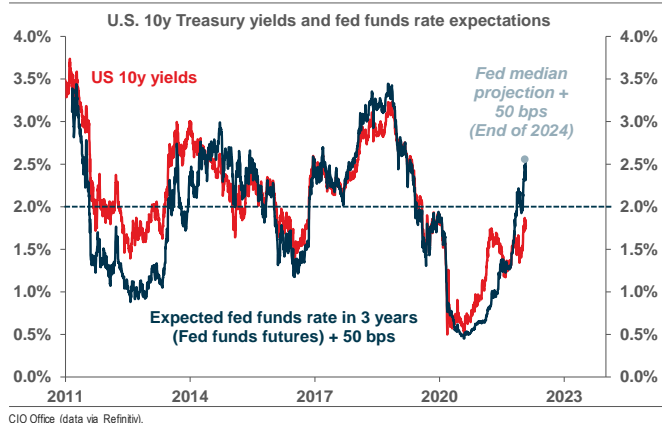
³ First Fed hike on the horizon – what's in store for markets?

17 | 10-year yields: modest upside potential...



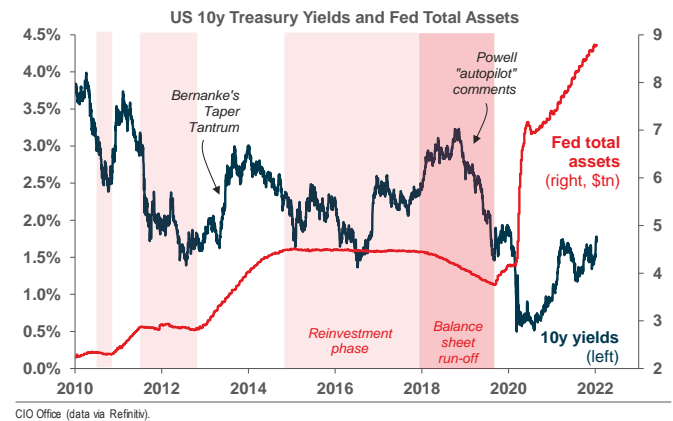
long as the Fed and markets do not change their terminal rate outlook for federal funds – a risk for 2023, more than 2022) (**Chart 18**). This is our baseline scenario.

18 | ... with a move above 2% likely in store



Could the gradual reduction of the Federal Reserve's balance sheet – which is expected to begin sometime this summer after a brief period of reinvestment – complicate matters? There is less historical precedent here. Yet, it is worth noting that balance sheet stabilization/reduction policies have rarely been a dominant factor for markets, except under two conditions: (1) following a miscommunication by Fed Chairs such as Bernanke in 2013 and Powell in 2018; and (2) when the size of the balance sheet is no longer sufficient to meet the market's liquidity needs, as in 2019 (**Chart 19**). For now, the main risk centres on the Fed's communication strategy, but the institution is clearly

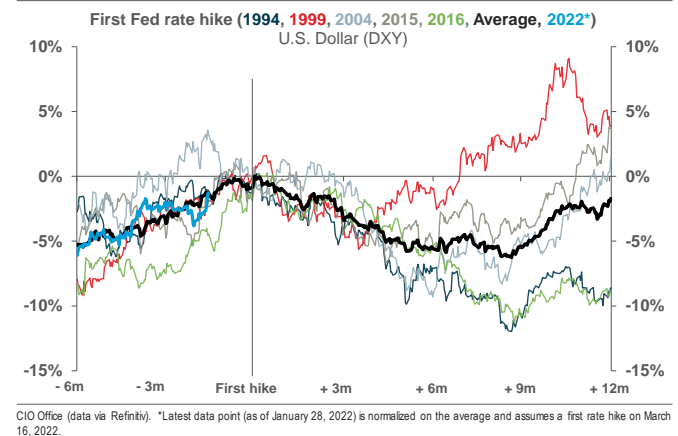
19 | Could the Fed's balance sheet complicate matters?



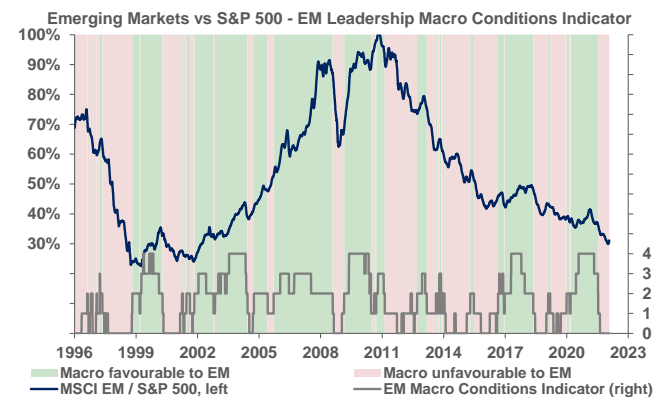
seeking to avoid repeating mistakes of the past, stating, for instance, that it intends to reduce its assets "in a predictable manner." We'll see but, for now, this is not a major source of concern.

Finally, one of the most persistent trends throughout the history of rate-hike cycles is the depreciation of the U.S. dollar (**Chart 20**). This suggests that while the Greenback still has near-term upside potential, it is likely to come down later in the year, possibly just as Chinese economic activity starts to benefit from more accommodative monetary and fiscal policies. If this trend reversal takes hold, it could open an opportunity in emerging markets which tend to do well under such conditions, but the stars do not yet seem to be aligned for the region (**Chart 21**, next page).

20 | A peak is looming for the U.S. dollar...

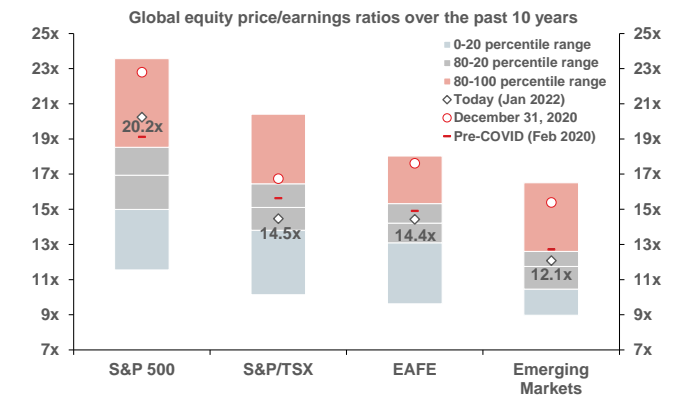


21 | ... which could pave the way for EM leadership



CIO Office (data via Refinitiv). The indicator measures 4 conditions: (1) USD on a downtrend, (2) broadbased global growth, (3) large majority of central banks accommodative, (4) EM positive relative momentum.

23 | ... with valuations near their pre-covid levels



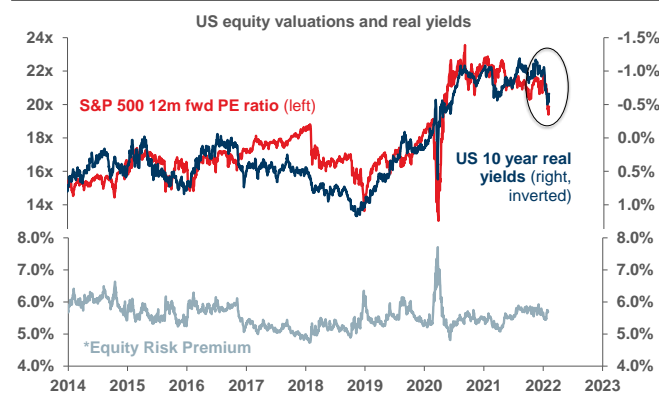
CIO Office (data via Refinitiv).

The Bottom Line

In this context, we took advantage of the pullback to increase our equity allocation on January 28, further reducing the weight of fixed-income securities, for which the outlook remains poor. We remain overweight cash.

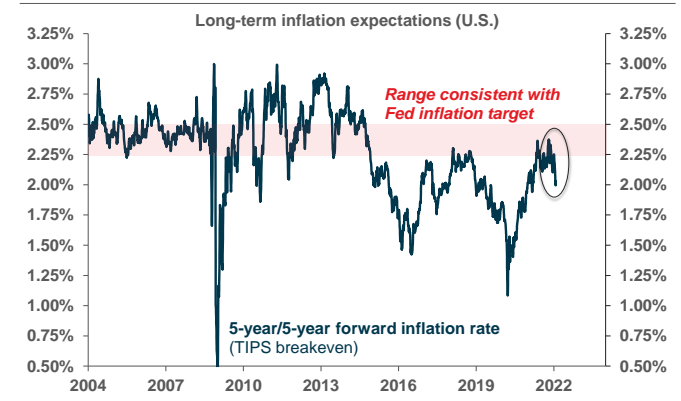
The rapid rise in real yields and, especially, the decline in stock market valuations suggest that much (if not too much) of the upcoming monetary tightening is now discounted by markets (**Chart 22**). Specifically, the P/E ratios of the main stock market indices have essentially completed their reversion to pre-pandemic levels (or even more, **Chart 23**).

22 | A lot of monetary tightening seems discounted...



CIO Office (data via Refinitiv). *S&P 500 earnings yield (1/PE) less 10-yr TIPS yields.

24 | Risk of hawkish surprises is limited

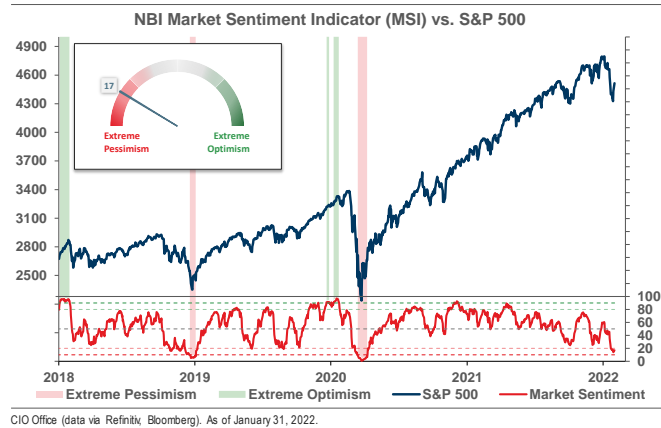


CIO Office (data via Refinitiv).

In any event, while there is no guarantee things won't deteriorate further in the near term (especially with the possibility of a more serious escalation of tensions between NATO and Russia), our market sentiment indicator reached its weakest since the March 2020 panic, an indication that downside

potential is relatively limited at these levels
(Chart 25).

25 | Sentiment is at its worst since March 2020



Moreover, at around 10% from the most recent peak, the U.S. stock market's decline neared the average magnitude of corrections since 1990, (outside of recession years) – an opportunity on a 12-month horizon for which the outlook for earnings growth remains strong. In fact, despite these occasional declines, 24 of the 27 recession-free years over this period have ended with gains averaging 15% (Chart 26).

26 | Corrections are normal and often an opportunity

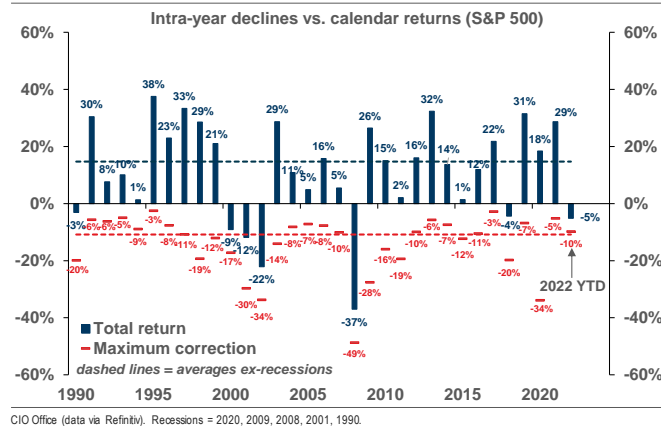


Table 3 Global Asset Allocation - Model Portfolio Weights (in CAD)

	Benchmark		Model Portfolio				Comments
	Total	Asset Class	Total		Asset Class		
			Allocation	Active Weight	Allocation	Active Weight	
Asset Classes							
Cash	0%	-	2.0%	2.0%	-	-	With above-trend global growth and recession-risk low, the outlook for equities compares favourably to bond markets. Alternatives allow for better control of the total risk of the portfolio and offers protection against sustained inflation. A modest cash position provides an extra level of prudence, given relatively weak risk-reward prospects across asset classes. Overall, this positioning is pro-risk.
Fixed Income	40%	-	30.0%	-10.0%	-	-	
Equities	60%	-	64.0%	4.0%	-	-	
Alternatives	0%	-	4.0%	4.0%	-	-	
Fixed Income							
Government	28%	73%	16.8%	-11.2%	54%	-18.8%	Accommodative monetary conditions and strong economic activity should lead corporate bonds to outperform government securities. For risk control purposes, we are sticking to investment grade credit. Treasury yields should rise modestly as central banks begin to normalize their policies, but we expect real yields to remain negative.
Investment Grade	12%	27%	14.2%	2.2%	46%	18.8%	
High Yield	0%	0%	0.0%	0.0%	0%	0.0%	
Duration	8.1 yrs	-	7.4 yrs	-0.7 yrs	-	-	
Equities							
Canada	21%	35%	23.5%	2.5%	37%	1.8%	Prevailing uncertainty argues for a diversified approach. Canada and the U.S. should outperform under a backdrop of slowing but strong global growth and slightly higher real yields. In EM, we favour cyclical and value sectors (RAFI Fundamental). In the U.S, we favour the high-quality (MSCI Quality) dividend-paying (Div. Aristocrats) companies and the equal weight index for their diversified and cyclical properties.
United States	21%	35%	23.5%	2.5%	37%	1.8%	
EAFE	12%	20%	11.6%	-0.4%	18%	-1.8%	
Emerging markets	6%	10%	5.3%	-0.7%	8%	-1.7%	
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) play an important role as diversifier. Gold prices may underperform if real yields rise, but remain an inexpensive insurance against the possibility that inflation continues to surprise to the upside.
Gold	0%	0%	2.0%	2.0%	50%	50.0%	
Non-Traditional FI	0%	0%	0.0%	0.0%	0%	0.0%	
Uncorrelated Strategies	0%	0%	2.0%	2.0%	50%	50.0%	
Foreign Exchange							
Canadian Dollar	61%	-	57.5%	-3.5%	-	-	Our overall portfolio strategy places us overweight in U.S. dollars versus our benchmark. Although we don't expect the Canadian dollar to depreciate significantly, we maintain this positioning for risk management purposes as the U.S. dollar offers attractive historical properties from a portfolio construction standpoint, especially paired with gold.
U.S. Dollar	21%	-	25.5%	4.5%	-	-	
Euro	5%	-	4.4%	-0.2%	-	-	
Japanese Yen	3%	-	2.9%	-0.1%	-	-	
British Pound	2%	-	1.6%	-0.1%	-	-	
Others	9%	-	8.0%	-0.7%	-	-	

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 color 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).

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General

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