Asset Allocation Strategy

CIO Office | December 2021

Exiting the Autobahn

Outlook 2022

NATIONAL BANK INVESTMENTS

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Exiting the Autobahn

Highlights

- At the end of last year, our Asset Allocation Strategy report entitled "Exit 2020, En Route to 2021" based its optimism for equity markets on an accelerating economic cycle, monetary conditions more accommodating than ever, and the onset of mass vaccination. Twelve months later, we see that the U.S. stock market ended up racing through 2021 at full throttle, exceeding the expectations of most investors, including us.

- Though record high inflation created some volatility at times, equity markets did not appear overly worried. A fundamental reason was that by calling inflationary pressures transitory from the start, the Federal Reserve had virtually removed any speed limit on prices in 2021, thereby allowing markets to engage in the economic equivalent of an autobahn.

- In 2022, we should see the economic cycle converge to a more sustainable pace as imbalances exacerbated by the pandemic begin to unwind, paving the way for the gradual normalization of ultra-accommodative monetary policies. This backdrop remains supportive for risk assets, although we should expect returns closer to historical averages and more volatility. The main risk factor will likely be the evolution of the major central banks' narratives toward inflationary pressures with dynamics complicated by a pandemic that still refuses to cooperate.

- Under these circumstances, the path of least resistance should remain upward for 10-year yields. However, total upside appears relatively limited and will likely be mostly driven by real yields with a first Fed rate hike on the horizon. For equities, this argues for a balanced approach between sectors and styles, which is what the U.S. and Canadian markets offer.

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** for details on the base-case economic scenario underpinning these views and **Table 4** to see how they translate into a model balanced portfolio.

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Market Review

Fixed Income

- Last month's inflation figures showed the U.S. reached a 30-year high year-over-year, while policymakers at the Federal Reserve announced it would begin tapering its monthly bond-buying program.
- As such, interest rate volatility was relatively elevated but, with rates lower by month's end, safer government bonds eked out positive performances.
- On the credit side, the discovery of a new COVID-19 "variant of concern[1]" brought about a widening of spreads as investor sentiment soured.

Equities

- U.S. equities made no less than 7 new highs in November, buoyed by a strong end to the latest earnings season.
- However, a resurgence in COVID-19 fears together with hawkish comments from Powell erased the month's gains for the S&P 500 in just a few trading sessions near the end of the month.
- Overall, the risk-off mood was felt across global markets, as both the MSCI EAFE and the MSCI EM indexes posted negative returns in November.

FX & Commodities

- The "variant of concern" weighed on oil prices as well, with the WTI facing its largest single-day drop since April 2020 on the news as traders feared the impact a resurgence in lockdowns and other health measures could have on demand for the commodity.
- On a related note, the Loonie lost ground throughout the month of November weighed down by falling oil prices and investors' risk aversion.

Table 2 **Market Total Returns**

Asset Classes	November	YTD	12 MTH
Cash (3-month T-bills)	0.0%	0.2%	0.2%
Bonds (FTSE CA Univ.)	**0.9%**	**-4.1%**	**-3.8%**
FTSE CA Short term	0.2%	-1.3%	-1.1%
FTSE CA Mid term	0.9%	-3.8%	-3.2%
FTSE CA Long term	1.6%	-7.9%	-7.5%
FTSE CA Government	1.0%	-4.6%	-4.4%
FTSE CA Corporate	0.5%	-2.8%	-2.1%
BoAML Inv. Grade ($US)	0.1%	-0.8%	-0.3%
BoAML High-Yield ($US)	-1.0%	3.4%	5.4%
Preferred Shares	-1.5%	17.8%	20.6%
CA Equities (S&P/TSX)	**-1.6%**	**21.4%**	**23.5%**
Energy	-5.3%	45.1%	46.0%
Industrials	-3.3%	16.7%	20.1%
Financials	-2.0%	28.6%	31.0%
Materials	1.1%	0.5%	3.7%
Utilities	-1.1%	5.4%	6.3%
Cons. Disc	0.6%	10.4%	16.8%
Cons. Staples	0.1%	12.0%	11.4%
Healthcare	-7.8%	-14.9%	-23.7%
IT	1.4%	26.8%	30.8%
Comm. Svc.	1.0%	20.1%	19.3%
REITs	-3.6%	29.1%	25.8%
S&P/TSX Small Cap	-3.6%	18.8%	25.7%
US Equities (S&P500 USD)	**-0.7%**	**23.2%**	**27.9%**
Energy	-5.1%	50.0%	56.6%
Industrials	-3.5%	15.0%	16.4%
Financials	-5.7%	30.7%	38.9%
Materials	-0.5%	18.3%	21.3%
Utilities	-1.7%	7.3%	8.1%
Cons. Disc	2.0%	24.7%	27.9%
Cons. Staples	-1.1%	7.6%	9.5%
Healthcare	-3.0%	15.7%	20.3%
IT	4.3%	30.1%	37.6%
Comm. Svc.	-5.2%	18.6%	22.2%
REITs	-0.9%	32.6%	34.6%
Russell 2000 (USD)	-4.3%	11.3%	20.8%
World Eq. (MSCI ACWI)	**-2.4%**	**14.4%**	**19.8%**
MSCI EAFE (USD)	-4.6%	6.3%	11.3%
MSCI EM (USD)	-4.1%	-4.1%	3.0%
Commodities (CRB index)	**-7.8%**	**30.7%**	**37.0%**
WTI Oil (US$/barrel)	-20.8%	37.1%	46.0%
Gold (US$/ounce)	0.2%	-6.2%	0.3%
Copper (US$/tonne)	-3.0%	22.8%	25.7%
Forex (DXY - USD index)	**2.0%**	**6.7%**	**4.5%**
USD per EUR	-2.7%	-8.0%	-5.9%
CAD per USD	3.1%	0.3%	-1.7%

Data via Refinitiv 2021-11-30

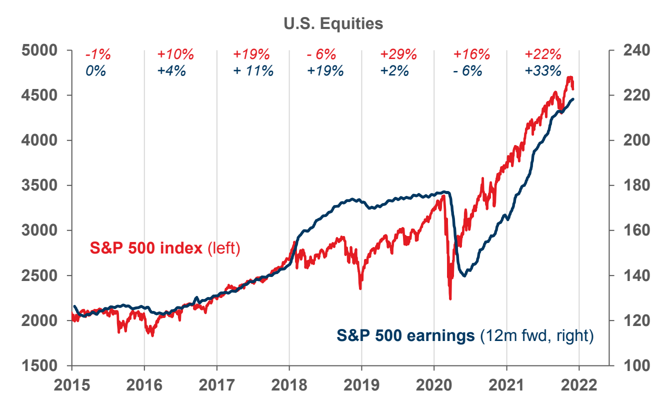
[1] Classification of Omicron (B.1.1.529) : SARS-CoV-2 Variant of Concern, WHO, November 26, 2021.

Exiting the Autobahn…

At the end of last year, our Asset Allocation Strategy report entitled "Exit 2020, En Route to 2021" based its optimism for equity markets on an accelerating economic cycle, monetary conditions more accommodating than ever, and the onset of mass vaccination.

Twelve months later, we see that the U.S. stock market ended up racing through 2021 at full throttle, delivering a 22% gain propelled by a 33% increase in forward earnings[2] – a performance exceeding the expectations of most investors, including us (**Chart 1**).

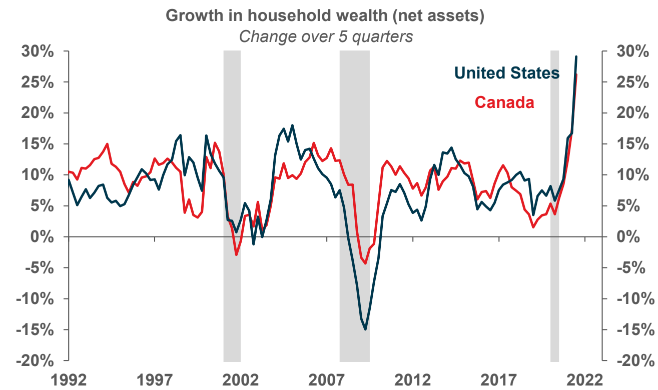
1 | Full throttle for US stocks in 2021



CIO Office (data via Refinitiv).

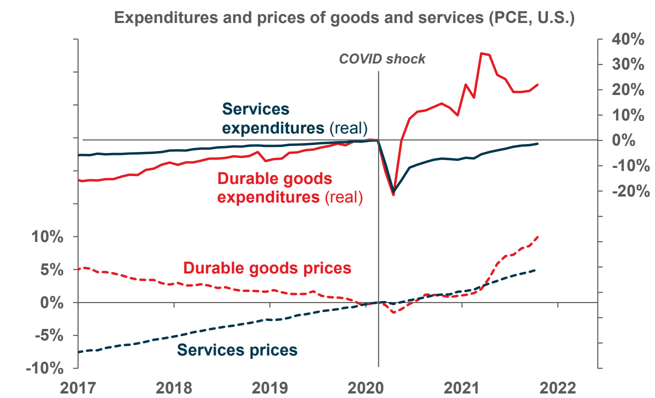
While the economic picture is quite positive, a look under the hood still shows significant imbalances. For instance, high savings rates, generous government income support measures, and increased financial asset prices have produced an unprecedented surge in household wealth (**Chart 2**) – great news in many respects. Yet, the relative persistence of the pandemic has had the effect of channelling this strong capacity to spend into goods, while spending on services lagged far behind (**Chart 3**).This divergence has put intense pressure on supply chains, already strained by a series of port and factory closures in Asia, forcing companies to drain their inventories like never before (**Chart 4**). And the ultimate consequence of these supply/demand imbalances: a three-decade

2 | An unprecedented increase in wealth…



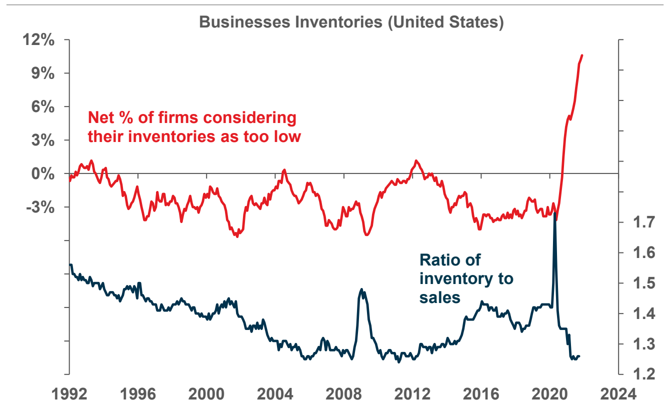
CIO Office (data via Refinitiv).

3 | ... and spending concentrated in goods...



CIO Office (data via Refinitiv).

4 | ... have seen inventories dry up...



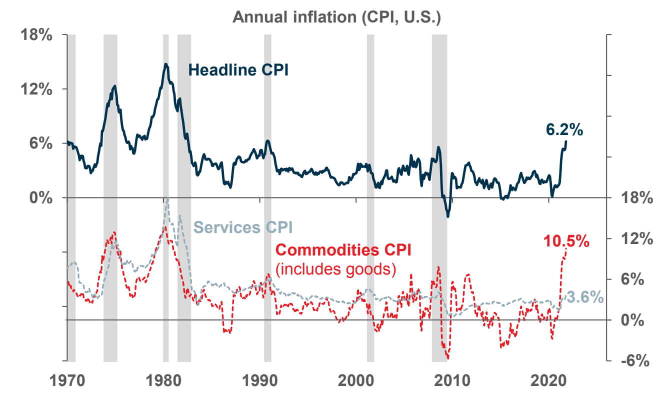
CIO Office (data via Refinitiv).

high for inflation, driven largely by rising goods prices (**Chart 5**, next page).

Though the pace of price increases has created some volatility at times, equity markets did not

[2] Year-to-date 2021 (from January 1 to November 30).

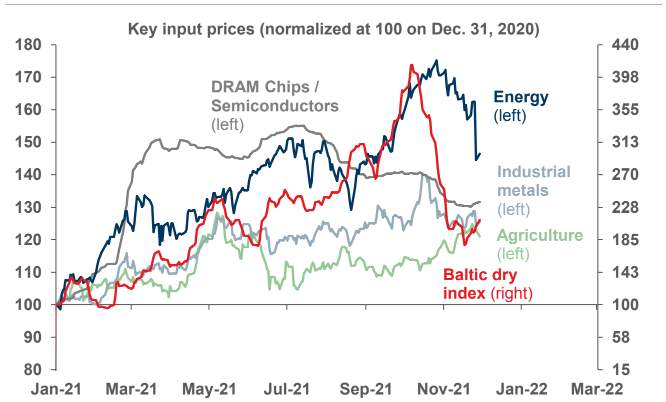
5 | … and inflation reach a three-decade high



CIO Office (data via Refinitiv).

appear overly worried. A fundamental reason is that by calling inflationary pressures transitory from the start, the Federal Reserve had virtually removed any speed limit on prices in 2021, thereby allowing markets to engage in the economic equivalent of an autobahn. In its favour, many of the elements behind the rise in inflation are clearly related to the imbalances amplified by the pandemic and, therefore, require time much more than restrictive monetary conditions to recede. In this regard, the decline in shipping costs (Baltic Dry Index) and semiconductor prices suggests that the transition back to equilibrium is underway, although the prices of several commodities remain stubbornly high (**Chart 6**).

6 | Some price pressures are easing

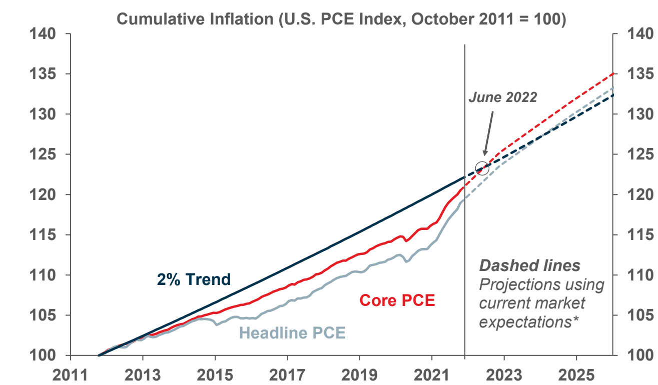


CIO Office (data via Refinitiv). As of November 29, 2021.

In any case, it appears clear that 2022 will be marked by a distinct shift in the Federal Reserve's monetary policy stance with a first interest rate hike for three main reasons.

First, the cumulative shortfall relative to the inflation target trend – the key element behind the Fed's tolerance for inflation figures well above 2% in 2021 – has narrowed significantly in recent months. It could even be completely closed by June 2022 for core PCE (**Chart 7**).

7 | The Fed's leeway on inflation is narrowing...



CIO Office (data via Refinitiv). *Projections implied from CPI Swaps and adjusted using the historical average spread between CPI and PCE YoY inflation of 49 bps since 1970.

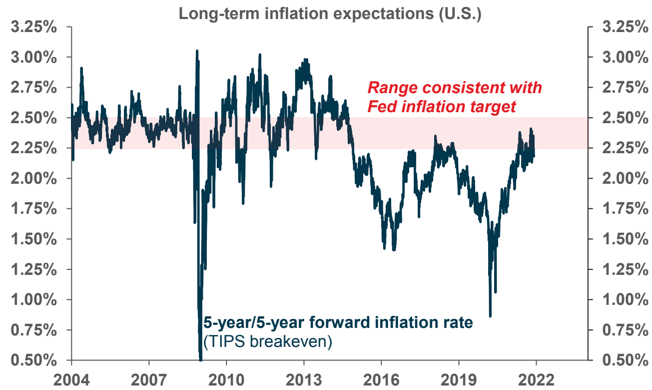
Second, long-term inflation expectations have returned to within the range consistent with the Fed's objective (**Chart 8**, next page) – a gauge that should be monitored closely as a move beyond (below) this comfort zone would risk pre-empting (delaying) rate hikes.

Third, the labour market is likely to reach a level consistent with the Fed's maximum employment goal – an imprecise label, but one generally believed to entail an unemployment rate between 3.5% and 4.0% (**Chart 9**, next page).

When will this prerequisite for a first rate increase be reached? By modelling the time to reach a 3.8%[3] unemployment rate as a function of net job creation and the participation rate, we find that it could definitely happen in the first half of 2022 (**Chart 10**, next page).

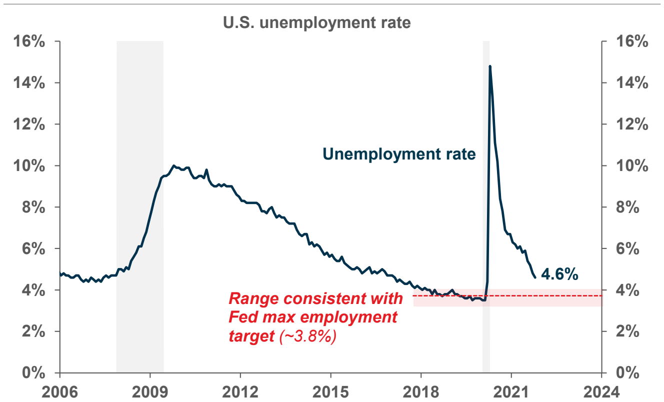
[3] Latest projections from FOMC members show an unemployment rate of 3.8% and one rate hike in 2022. We can, therefore, consider 3.8% as a level of unemployment rate suitable for a first rate hike.

8 | ... while long-term expectations have recovered



CIO Office (data via Refinitiv).

9 | "Maximum employment" in a few months?...



CIO Office (data via Refinitiv).

10 | … seems quite likely…

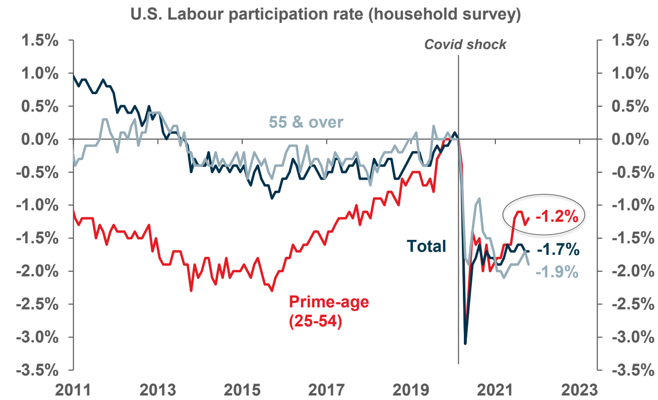
Number of months until U.S. unemployment rate reaches 3.8%

Monthly change in total participation rate	Monthly change in total jobs: 265k	315k	365k	415k	465k (3m avg)	515k	565k	615k	665k
-0.04%	4m (Mar 22)	4m (Mar 22)	3m (Feb 22)	3m (Feb 22)	3m (Feb 22)	3m (Feb 22)	2m (Jan 22)	2m (Jan 22)	2m (Jan 22)
-0.02%	5m (Apr 22)	4m (Mar 22)	4m (Mar 22)	3m (Feb 22)	3m (Feb 22)	3m (Feb 22)	3m (Feb 22)	2m (Jan 22)	2m (Jan 22)
0.00%	6m (May 22)	5m (Apr 22)	4m (Mar 22)	4m (Mar 22)	3m (Feb 22)	3m (Feb 22)	3m (Feb 22)	3m (Feb 22)	2m (Jan 22)
0.02%	8m (Jul 22)	6m (May 22)	5m (Apr 22)	4m (Mar 22)	4m (Mar 22)	3m (Feb 22)	3m (Feb 22)	3m (Feb 22)	3m (Feb 22)
0.04%	11m (Oct 22)	8m (Jul 22)	6m (May 22)	5m (Apr 22)	4m (Mar 22)	4m (Mar 22)	3m (Feb 22)	3m (Feb 22)	3m (Feb 22)
0.06%	21m (Aug 23)	11m (Oct 22)	8m (Jul 22)	6m (May 22)	5m (Apr 22)	4m (Mar 22)	4m (Mar 22)	3m (Feb 22)	3m (Feb 22)
0.08%	-	22m (Sep 23)	11m (Oct 22)	8m (Jul 22)	6m (May 22)	5m (Apr 22)	4m (Mar 22)	4m (Mar 22)	3m (Feb 22)
0.10%	-	-	22m (Sep 23)	12m (Nov 22)	8m (Jul 22)	6m (May 22)	5m (Apr 22)	4m (Mar 22)	4m (Mar 22)
0.12%	-	-	-	22m (Sep 23)	12m (Nov 22)	8m (Jul 22)	6m (May 22)	5m (Apr 22)	4m (Mar 22)

CIO Office (data via Refinitiv).

Here, the key variable to watch will be the participation rate, as a whole, but especially in the prime working age group (25-54) which surprisingly remains well below its pre-pandemic level (**Chart 11**). This is an important issue in the eyes of the Federal Reserve, which will certainly want to see a significant improvement in this regard before proceeding with rate hikes.

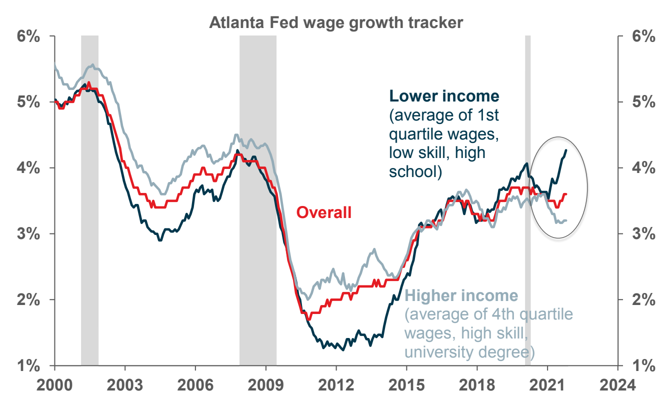
11 | … but watch for labour participation rate(s)



CIO Office (data via Refinitiv).

Why do so many workers remain on the sidelines in the United States? It is not entirely clear (see this Financial Times article[4] for some answers) – yet, one thing is certain. As time goes on, the accumulated savings cushion that seemingly enticed many to have patience diminishes, and rising wages (especially at the lower income level, **Chart 12**) become an increasingly attractive incentive.

12 | Shifting trends for wage growth



CIO Office (data via Refinitiv).

Concretely, our colleagues at NBF Economics and Strategy project that this environment will lead to 2 rate hikes for the Federal Reserve in 2022, with the first in September. In Canada, where the job market

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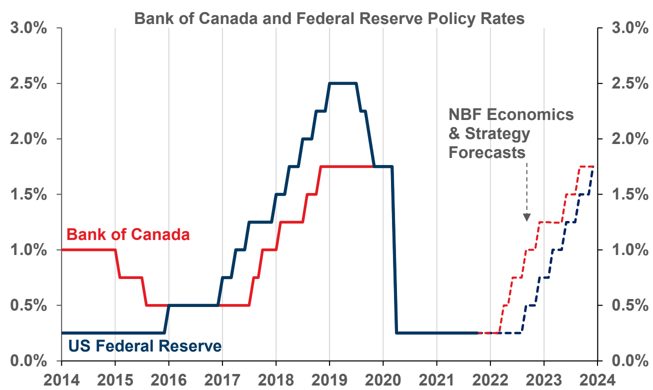
[4] Where did all the workers go? Financial Times, November 22, 2021.

has recovered more quickly and the Central Bank is less tolerant vis-à-vis inflation, a first hike should come as early as April, followed by 3 more over the course of the year (**Chart 13**).

13 | Rate hikes are in store for 2022...



CIO Office (data via Refinitiv, NBF Economics and Strategy). Forecasts as of November 10, 2021.

For inflation, we are likely nearing a peak as a shift in demand from goods to services should help ease pressures on supply chains and overall prices. Nevertheless, this process will take time, such that inflation figures will remain visibly elevated in 2022, while other structural factors (such as labour shortages) are likely to result in a prolonged period of slightly higher price growth than in the previous decade (**Chart 14**).

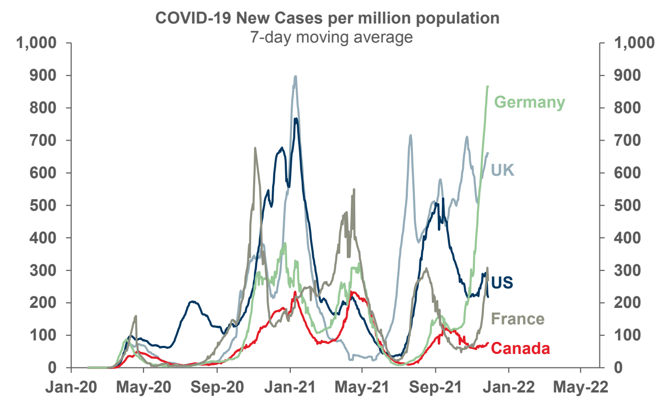
14 | … while inflation should soon peak

CIO Office (data via Refinitiv). *CPI Inflation Swaps

This interplay between monetary policy normalization and volatile inflation should be the main source of uncertainty in 2022. The challenge for central banks is sizeable, blind spots are numerous, and the policy mistake risk tilts to both sides of the road (i.e., tightening monetary conditions too quickly or too slowly).

Could COVID-19 completely disrupt this scenario? If the last 2 years have taught us anything, it is that we can never take anything for granted during a pandemic. The recent increase in new cases in Europe (**Chart 15**) and the arrival of the new Omicron variant demonstrate that we have no other choice but to learn to live with this threat.

15 | The pandemic has not said its last word...



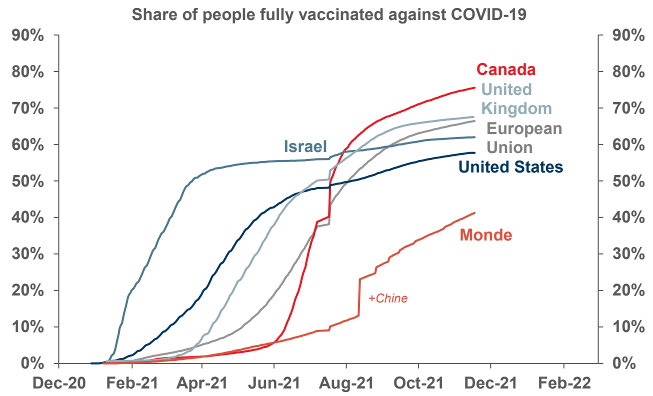
CIO Office (data via Johns Hopkins University).

Fortunately, we are increasingly well equipped, whether in terms of vaccination which continues to progress worldwide (**Chart 16**, next page), antiviral treatments which show promise[5] or, more generally, in terms of procedures (targeted and measured restrictions, masks, capacity to develop new vaccines, etc). As such, the likelihood of renewed draconian measures on mobility (**Chart 17**, next page) serving as a blow to economic growth remains limited.

What, then, can we reasonably expect for markets under these circumstances (beyond the inevitable surprises)? To answer this, we continue with a concise review of cyclical and monetary conditions as well as valuations. We then dive into the implications within major asset classes.

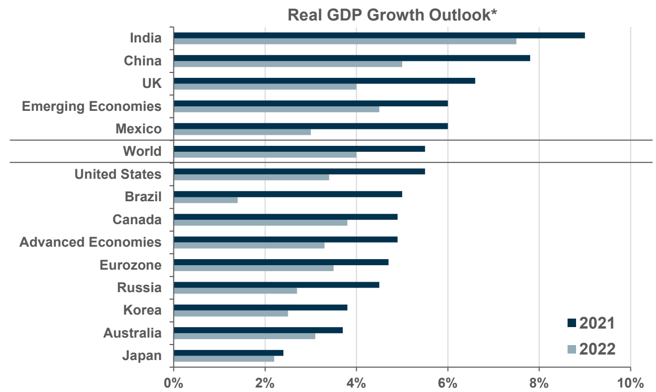
5 Treatments will change the pandemic, but they can't end it alone, Washington Post, November 21, 2021.

16 | ... but a better pandemic toolbox...



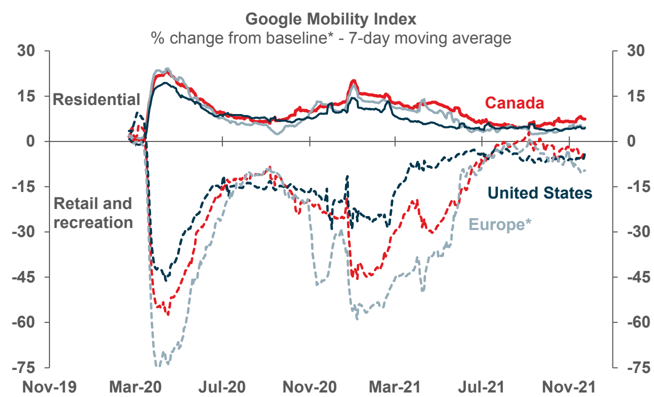
CIO Office (data via OWID).

18 | Economic growth is set to remain strong...



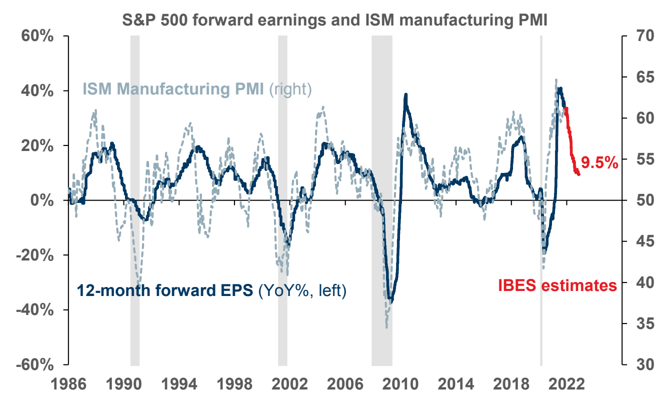
CIO Office (data via NBF Economics & Strategy). *Forecasts as of November 12, 2021.

17 | ... should ensure a certain degree of normalcy



CIO Office (data via Google). *Average of Germany, France, UK.

19 | ... although a slowdown is inevitable…



CIO Office (data via Refinitiv).

… One Lane at a Time

Overall, **cyclical conditions** remain pro-risk since, although growth is inevitably set to slow, it is expected to remain strong and above historical averages (**Chart 18**).

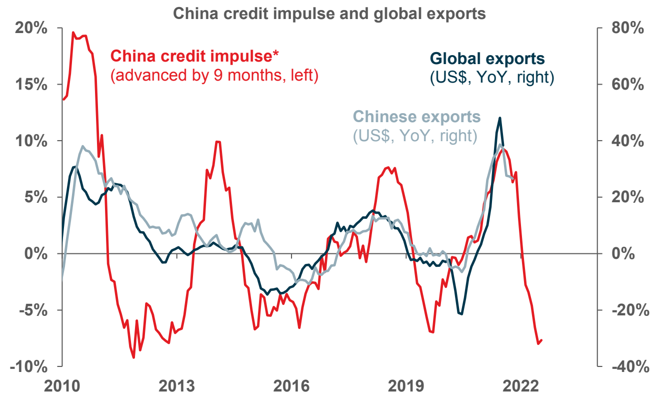
One element to watch for is manufacturing activity, closely tied to S&P 500 earnings growth (**Chart 19**). In both cases, we should indeed expect a slowdown. However, the need to replenish depressed inventories along with high capital spending intentions of many companies should support a high level of economic activity throughout the year.

A key risk factor in 2022 will be Chinese growth, given the conservative approach of the country's policymakers to COVID-19[6] and monetary conditions. The export boom resulting from record demand for goods has been a major contributor to China's (and the world's) economic strength over the past year. Again, despite a shift in demand from goods to services, growth is likely to persist given the low level of inventories. However, downside risks are more pronounced given the current credit growth figures, which the Chinese authorities are clearly trying to constrain (**Chart 20**, next page).

Notwithstanding China's idiosyncracies, **monetary conditions** also continue to broadly favour risk assets. Recall that recessions are generally preceded by a period of restrictive interest rates, that is, above a level considered "neutral"

[6] Why China is still trying to achieve zero Covid, BBC, November 15, 2021.

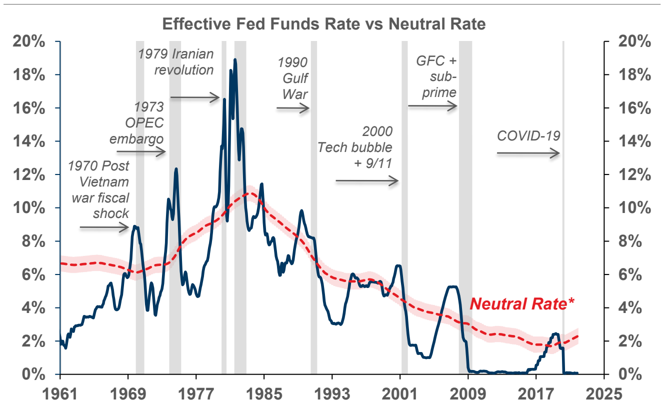
20 | ... notably in China



CIO Office (data via Refinitiv). *YoY change in China total social financing in % of GDP.

(**Chart 21**). With a projected Federal funds rate of 0.75% at the end of 2022 and 1.75% at the end of 2023[7] (i.e. only back to its pre-COVID level!) vs. a neutral rate estimated to range between 2.00% and 3.00%[8], the term "less accommodative" seems more appropriate for now.

21 | Policy rates will remain accommodative

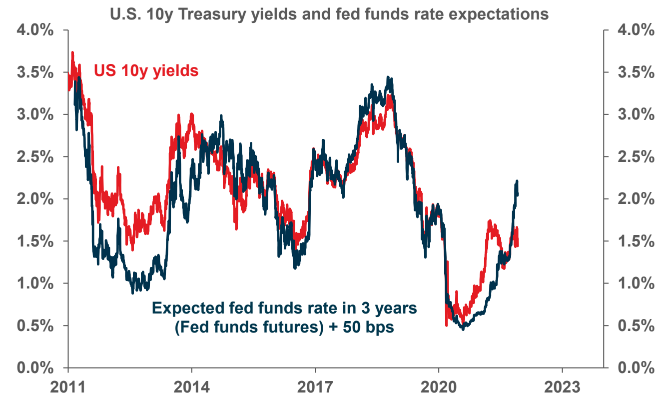


CIO Office (data via Refinitiv). *Estimates of the baseline model described in «Measuring the Natural rate of Interest» by Thomas Laubach and John C. Williams + last ten-year average core PCE inflation (last number set at 2%) +/- 50 basis points.

In this environment, the path of least resistance should remain upward for 10-year yields, which tend to move in sync with the Fed's medium-term rate outlook (**Chart 22**).

That said, much of the rebound in long rates has already taken place over the past year, whereas it is potentially below the surface that the most interesting movements could occur in 2022. Indeed, the upside potential appears limited for 10-year

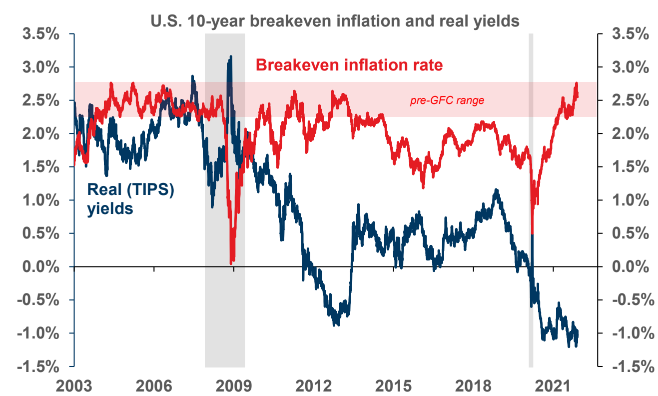
22 | The path of least resistance is up for 10y yields…



CIO Office (data via Refinitiv, bloomberg).

breakeven inflation (the spread between the rate on a traditional and real TIPS bond) after a year marked by exceptional inflationary surprises that pushed it to its highest level in nearly 15 years (**Chart 23**).

23 | … but mostly for real yields…



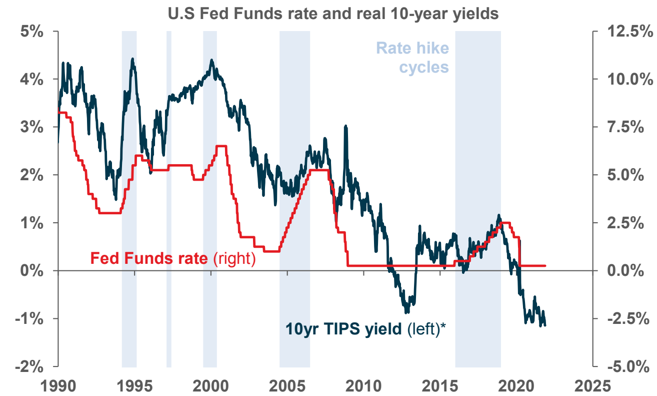
CIO Office (data via Refinitiv).

On the flip side, the beginning of a rate hike cycle by the Fed suggests a gradual rise in real yields, as has generally been the case under such conditions (**Chart 24**, next page).

For equity markets, this tangent may exert downward pressure on price-earnings (P/E) multiples. Real yields and P/E ratios, two variables at the basis of the equity risk premium (ERP), have been tracking each other closely for several years (**Chart 25**, next page).

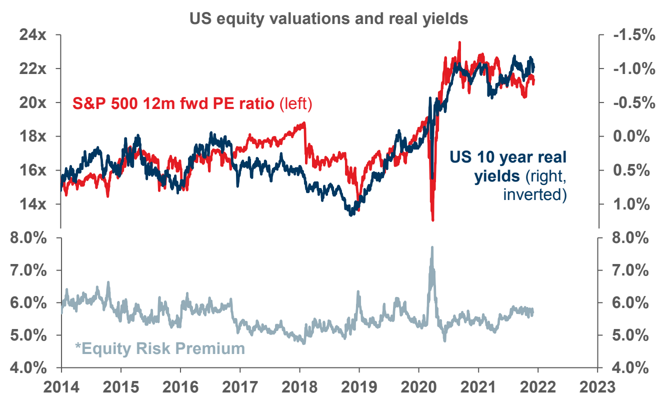
[7] Source : NBF Economics and Strategy
[8] Latest long-term projection of FOMC members (2.5%) +/- 50 bps.

24 | ...largely influenced by the Fed...



CIO Office (data via Refinitiv). *TIPS yield since 1997, nominal less rolling 10yr CPI before.

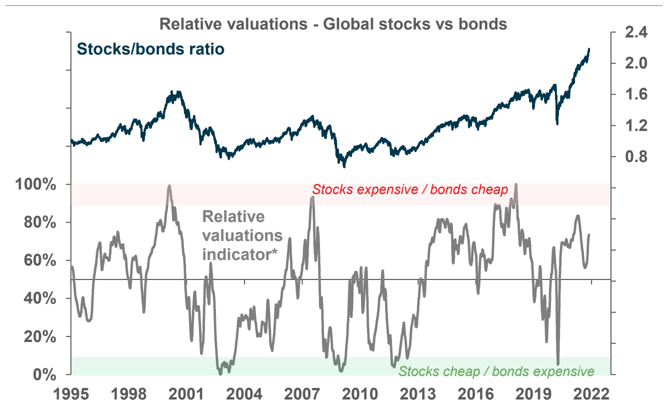
25 | ... which could weigh on equity multiples



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

However, the gradual and conditional approach to Fed policy normalization suggests only a moderate increase in real yields, which should remain negative for an extended period. Furthermore, our relative **valuation** indicator for global equity and bond markets still does not signal the need to move either way on this basis (**Chart 26**).

26 | No relative overshoot for stocks/bonds valuations



CIO Office (data via Refinitiv). *Composite indicator of S&P/TSX, S&P 500, MSCI EM and MSCI EAFE valuations relative to government bond yields.

Bottom Line: Investment Strategy

In summary, 2022 should see the economic cycle converge to a more sustainable pace as the imbalances exacerbated by the pandemic begin to wind down, paving the way for the gradual normalization of ultra-accommodative monetary policies. This backdrop remains supportive for risk assets, although we should expect returns closer to historical averages and more volatility after an especially profitable period. The main risk factor will likely be the evolution of major central banks' narratives toward inflationary pressures with dynamics complicated by a pandemic that still refuses to cooperate. Under the circumstances, we begin the year by maintaining a tactical allocation **across asset classes** overweighted in equities and cash against fixed income.

Working with the assumption that the trough in real yields is behind us, we have analyzed how different assets have historically performed in conjunction with this important macroeconomic variable. While caution should be exercised before drawing firm conclusions based on simple historical averages, some findings are nonetheless revealing.

The most compelling evidence is that it is fixed-income assets that have the most to lose in a rising real rate environment. For equities, while they have indeed tended to be more volatile under such circumstances, their average returns have actually been higher (**Chart 27**, next page) – good reminder that rising real rates are often indicative of a strong economy.

Within the **bond market**, corporate and shorter duration securities should outperform for similar reasons. However, from a total portfolio perspective, the risk/return outlook remains weak for the overall market when compared to stocks. As we stated at this time last year, we favour deploying risk in equities, which have effectively outperformed high-yield bonds since then, unlike during previous post-recession periods (**Chart 28**, next page).

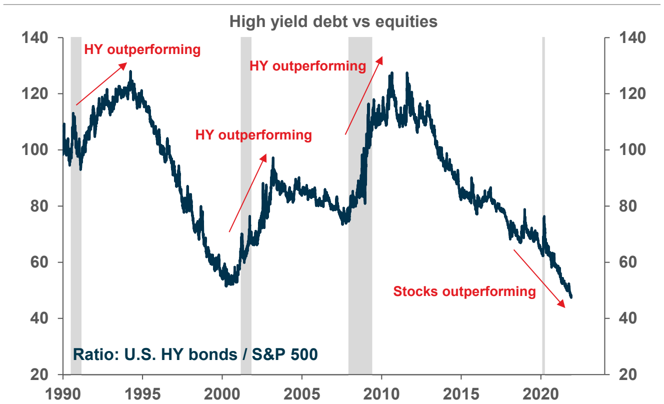
27 | What happens when real yields are ↑ vs ↓ ?

Return and volatility when U.S. 10-yr TIPS yields are up /down YoY (data since 1990)*

		Average total return			Volatility		
		Real yields up	Real yields down	Difference (up vs down)	Real yields up	Real yields down	Difference (up vs down)
Equities	Momentum	18%	14%	4.5%	20%	18%	2.2%
	Growth	15%	11%	4.7%	18%	17%	1.4%
	Quality	15%	12%	3.2%	17%	16%	1.7%
	S&P 500	13%	11%	2.7%	18%	16%	2.0%
	Small	12%	12%	-0.6%	22%	21%	0.7%
	MSCI EAFE	12%	13%	-1.8%	25%	20%	5.4%
	Value	11%	11%	0.7%	20%	17%	2.5%
	S&P/TSX	11%	8%	2.4%	17%	16%	1.4%
	MSCI EM	10%	5%	4.5%	17%	18%	-0.6%
Fixed Income	CA Long (FTSE)	5%	12%	-7.2%	8%	8%	0.1%
	U.S. High Yield	5%	12%	-7.3%	7%	6%	0.5%
	CA Corp (FTSE)	5%	10%	-5.5%	5%	5%	0.0%
	CA Universe (FTSE)	4%	9%	-4.8%	5%	5%	-0.1%
	CA Short (FTSE)	4%	7%	-2.6%	3%	3%	-0.1%
Alts & FX	US Dollar (DXY)	3%	-1%	3.9%	7%	8%	-0.7%
	Commodities (GSCI)	2%	7%	-5.0%	21%	21%	-0.7%
	Gold	-1%	12%	-12.7%	17%	16%	0.8%
	TIPS (since 2002)	-3%	15%	-17.7%	11%	13%	-1.7%

CIO Office (data via Refinitiv). *Minimum of 20 bps YoY move. TIPS yields since 1997, nominal yields less CPI inflation before.

28 | Equities retain the edge

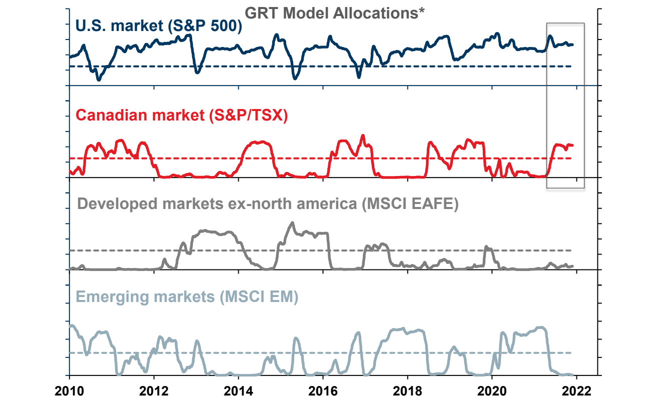


CIO Office (data via Refinitiv).

Within the **equity markets**, we continue to promote diversification and avoid aggressive deviations given the heightened level of uncertainty and, more importantly, the pace at which things are evolving. That said, we now favour all North American equities (Canada and U.S.) over foreign equities (EAFE and EM) for three main reasons.

First, this positioning mirrors the signals sent by our Geographical Relative Trend (GRT) model (**Chart 29**). The main value of this tool is to continually confront any investment thesis with the reality of markets. A good example of this is the nearly uninterrupted underperformance of the EAFE region over the last decade. One would think that its heavier weightings in financials and industrials would have made it a top-performing asset in 2021, given the economic boom that has occurred. However, other factors (likely more structural) have

29 | The positive trend persists in North America



CIO Office (data via Refinitiv). *vs equalweight benchmark,.

continued to weigh on the region, and it is not clear that it will be any different in 2022.

Second, a mix of Canadian and U.S. equities offers reasonable diversification between defensive/growth (S&P 500) and cyclical/value (S&P/TSX) stocks. Although 10-year bond yields are likely to end higher in 2022 – a generally supportive factor for cyclical/value stocks (**Chart 30**) – their upside potential is no longer as large.

30 | Cyclical stocks should do well...

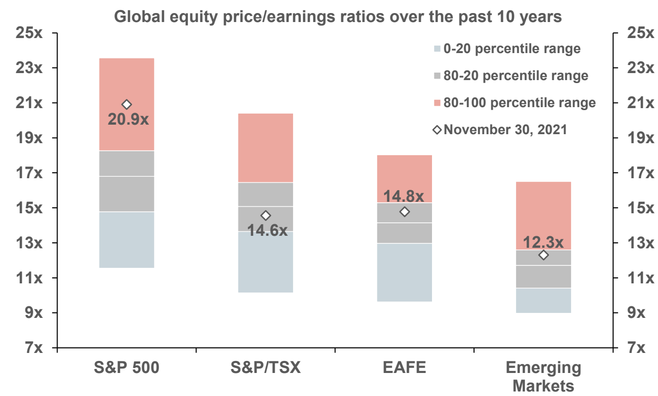
CIO Office (data via Refinitiv). *Cyclicals/Value = Financials, Materials, Energy, Industrials, Real Estate, Cons. Discr.. Defensive/Growth = Utilities, Cons. Staples, Health Care, Technology, Telecom.

Moreover, this relationship seems to depend mostly on expected inflation, whereas growth stocks have tended to do well in the context of rising real yields (see ***Chart 27*** again). Accordingly, we expect to migrate further into higher growth stocks during the year should a peak in inflation be confirmed. Until then, we still consider the quality factor – highly correlated to growth (**Chart 31**, next page) – as an attractive alternative for investors seeking exposure

31 | ... but a diversified approach is warranted

CIO Office (data via Refinitiv).

33 | … and their valuations, not an outright bargain

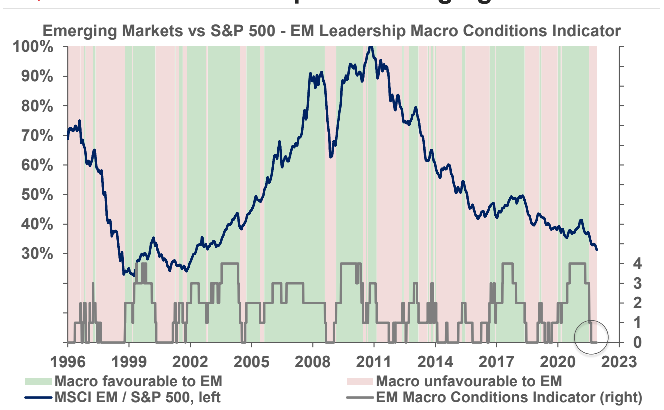


CIO Office (data via Refinitiv).

to this potential rotation while limiting exposure to stocks prized by speculators.

Third, headwinds are picking up for emerging markets and, for now, the trend doesn't look to be changing. In addition to heightened regulatory risk in China, tighter monetary conditions, slowing global growth and an upwardly trending U.S. dollar are all factors that have historically worked against the region, as reflected by our model verifying these conditions (**Chart 32**). These developments have already led to significant underperformance in 2021, but not enough to push emerging market valuations (slightly above their 10-year average, **Chart 33**) within bargain territory.

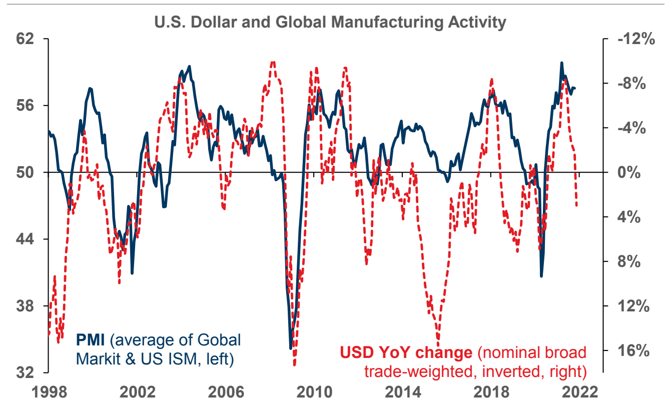
32 | The macro backdrop is challenging for EM…



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

Of the factors mentioned influencing emerging markets, the one for which the trajectory is less clear is **currencies** and, more specifically, the U.S. dollar. Although the Greenback tends to appreciate when real rates are rising, it has already seemingly discounted the coming economic slowdown (**Chart 34**), which suggests relatively limited upside potential.

34 | The US$ is (already) discounting a slowdown

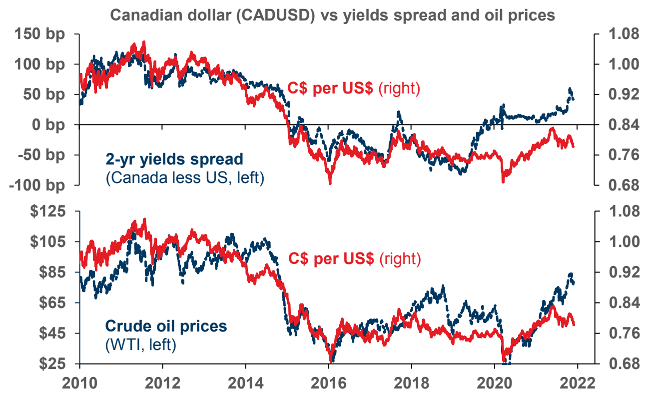


CIO Office (data via Refinitiv).

Going forward, the determining factor will unequivocally be how quickly the Federal Reserve reduces its asset purchases and migrates toward a first rate hike. In our specific case, it seems clear that the Fed will be more patient than the Bank of Canada, as reflected by 2-year yield spreads. Such an environment, in addition to high oil prices, tends to support the Canadian dollar (**Chart 35**, next page).

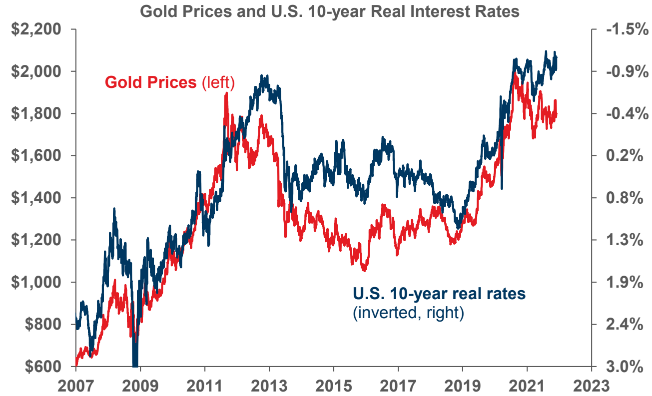
That said, from a portfolio management standpoint, we still believe that the U.S. dollar offers a diversification effect all the more pertinent in pandemic times. Furthermore, the current level of the Loonie is nearly right on our measure of intrinsic

35 | The Canadian dollar has the wind at its back...



CIO Office (data via Refinitiv).

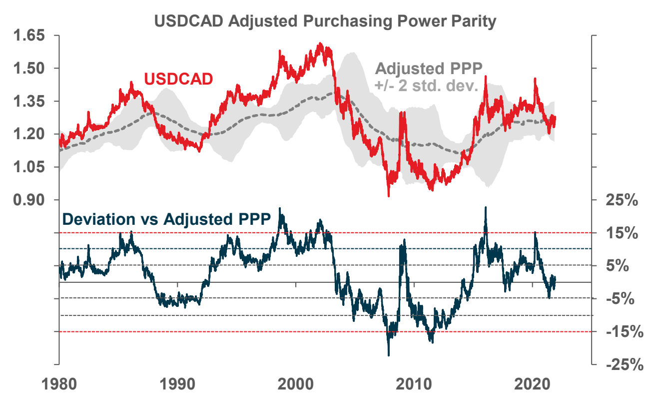
37 | Gold: an inexpensive insurance policy



CIO Office (data via Refinitiv).

value based on purchasing power parity and, therefore, does not signal a major opportunity one way or the other (**Chart 36**).

36 | ... but does not signal a major opportunity



CIO Office (data via Refinitiv).

Finally, within **alternative assets**, Treasury Inflation-Protected Securities (TIPS) have performed particularly well in 2021 (+ 5.1% vs. - 5.3% for the Canadian bond market year to date). It will naturally be difficult to repeat the experience, if expected inflation stabilizes while real yields begin to rise. On the other hand, a systematic quantitative strategy that takes advantage of market trends, while aiming for maximum decorrelation with equities and tight control of volatility, should take on the role of diversifier, while generating positive returns. Gold prices are also likely to underperform if real yields rise (**Chart 37**). However, they remain an inexpensive insurance against the possibility that inflation continues to surprise to the upside.

Table 3 Base Case Scenario

Scenario (prob.*)	Key elements and investment implications
Base case 70%	Waves of new COVID-19 cases arise at different times in different countries. The number of hospitalizations and deaths fluctuates, but remains far from reaching a state of crisis thanks to the success of the vaccination campaigns that are ramping up in developing countries.
	The economic recovery continues, but the pace of growth slows. Strong underlying trends such as a substantial accumulation of excess savings, a strong recovery in the service sector and accommodative monetary conditions maintain growth rates above their long-term average.
	The majority of developed countries policy makers pursue a gradual and cautious phase-out of emergency fiscal support. In the U.S., the Biden administration manages to pass a social package that includes some tax increases, albeit of a smaller magnitude than originally planned.
	Annual inflation declines slightly but remains volatile. Several transitory forces exerting upward pressure on prices abate. Still, a strong economy and structural factors keep inflation relatively high. Central banks initiate a gradual and cautious adjustment of their ultra-accommodative monetary policies.
	→ **Bond yields rise gradually while global equities continue to rise along their long-term trend. Leadership remains volatile but edge in favour of cyclical and canadian equities.**
Bullish 15%	A decline in COVID-19 infectiousness combined with an increase in global vaccination rates allows for a definitive victory over the pandemic. As economies reopen, employment recovers rapidly. Consumer sentiment jumps.
	After rising sharply, inflation settles near historical averages as supply adjusts. Chinese monetary authorities announce new measures to stimulate their economy while Western central banks keep policy rates at record lows.
	→ **Bond yields rise marginally while the U.S. dollar depreciates. Global equities surge above their long-term trend. Leadership remains volatile. Emerging markets equities outperform significantly.**
Bearish 15%	Strong inflationary pressures push long-term inflation expectations into a range that forces central banks to tighten monetary conditions earlier than expected. In parallel, ncertainty over U.S. fiscal policy, monetary and regulatory policies in China, and Sino-U.S. relations force markets to recalibrate their expectations.
	Vaccination campaigns fail to counter the rapid spread of coronavirus variants in some parts of the world. Persistent fears over the disease affect consumer sentiment negatively, global growth slows substantially.
	→ **Bond yields volatility increases and the U.S. dollar shoots higher. Equities venture in correction territory. Leadership is highly volatile but edges in favour of growth (value) stocks in the COVID revival (inflationary pressure) scenario.**

CIO Office. Last update: October 1, 2021 (updated quarterly unless an event demands a revision). *Subjective probabilities based on current market conditions and subject to change without notice.

Table 4 Global Asset Allocation - Model Portfolio Weights (in CAD)

	Benchmark		Model Portfolio				Comments
	Total	Asset Class	Total Allocation	Total Active Weight	Asset Class Allocation	Asset Class Active Weight	
Asset Classes							
Cash	0%	-	2.0%	2.0%	-	-	With above-trend global growth, the outlook for equities compares favourably to bond markets, which are showing real yields close to an all-time low. 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%	-	31.0%	-9.0%	-	-	
Equities	60%	-	63.0%	3.0%	-	-	
Alternatives	0%	-	4.0%	4.0%	-	-	
Fixed Income							
Government	28%	73%	16.8%	-11.2%	54%	-18.8%	Accommodative monetary conditions and strong recovery in 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%	23.0%	2.0%	37%	1.6%	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 properties.
United States	21%	35%	23.0%	2.0%	37%	1.6%	
EAFE	12%	20%	11.6%	-0.4%	18%	-1.6%	
Emerging markets	6%	10%	5.3%	-0.7%	8%	-1.6%	
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%	-	58.0%	-3.0%	-	-	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 pared with gold.
U.S. Dollar	21%	-	25.0%	4.0%	-	-	
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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