NATIONAL BANK INVESTMENTS

ASSET ALLOCATION STRATEGY

April 2020

Down in History

Highlights

> After a run of 11 years (almost to the day), the S&P 500 bull market came to an abrupt end in March, as a rapidly evolving pandemic forced governments around the world to pull the emergency brake on their respective economies in an unprecedented fashion. The end result is the worst quarter for U.S. equities (-20%) since 2008.

> What now? Should we further reduce our equity allocation, having gone to neutral early in the crisis? Or, should we take advantage of the stock market downturn in anticipation of a rebound? To be sure, we begin this month's report with an assessment of the four pillars of asset allocation, namely (1) investors' sentiment, (2) valuations, (3) monetary conditions, and (4) global growth.

> Simply put, for investor sentiment to strengthen, equity valuations to recover, monetary and fiscal conditions to gain full traction, and global growth to bottom out, the problem at the root of all this turmoil must subside. That is, COVID-19's exponential propagation must be slowed down. Encouragingly, the situation remains under control in Asia and appears to be stabilizing in Italy. But, it is deteriorating considerably in the United States, where the number of new cases continues to grow faster and higher than anywhere else. As such, while conditions are lining up for a stock market rebound ahead of an economic restart, the overall situation remains precarious and still calls for caution in the short-term – hence why we remain neutral on equities with extra cash on hand.

> Consistent with its counter-cyclical habits, the U.S. dollar has appreciated sharply over the past month – a positive for Canadians invested in U.S. dollar-denominated assets, but less so for the global financial conditions. If the uptrend were to accelerate and jeopardize the stability of the world economy, we wouldn't be surprised to see a multi-country agreement explicitly aimed at devaluing the U.S. dollar. We're not there yet and may never need to be, but it's certainly something we'll be following closely.

> The storm which equity markets are going through has revived several trends that characterized much of the last year. Specifically, defensive, growth, large, and U.S. equities have all surpassed their cyclical, value, small, and foreign (World ex-U.S.) relatives so far this year. A sharp and sustained reversal of these trends is unlikely to occur until investor risk appetite and global growth prospects improve. But when such time comes, we will likely be looking to increase our allocation in emerging markets.

> Crude oil prices completely collapsed in March, as the combination of falling demand and rising supply delivered a KO, one-two punch to the commodity. We advise caution in taking positions in financial assets that are tied to energy prices. The situation may remain problematic for some time and even deteriorate before the inevitable rebound takes place. Turning to gold, shouldn't the price of this safe haven have soared amid such uncertain times? Not if a recession drives inflation to the ground and spurs the Greenback, as we've previously warned. Nevertheless, with central banks pledging their balance sheets to ensure sufficient liquidity and low nominal yields in addition to their clear incentives to put a cap on U.S. dollar strength, gold could fare relatively well over the coming year.

> At current levels, the incremental return potential for government debt securities seems fairly limited. On the other hand, the investment-grade corporate credit market – which the Federal Reserve has essentially committed to protect from default – exhibits attractive valuations.

Table 1 **Global Asset Allocation**

Global Classes	−	Weights			+
Cash				Current	
Fixed Income		Current			
Equities			Current		
Fixed Income					
Federal		Current			
Investment Grade			Previous	Current	
High Yield (USD)		Current	Previous		
Non-Traditional FI				Current	
World Equities					
S&P/TSX			Current		
S&P 500 (USD)				Current	
MSCI EAFE (USD)		Current			
MSCI EM (USD)			Current		
Factors and Alternative Investments					
Value vs. Growth			Current		
Small vs. Large			Current		
Low Vol. vs. High Beta			Current		
Canadian Dollar			Current		
Commodities			Current	Previous	
Energy			Current	Previous	
Base Metals			Current	Previous	
Gold			Previous	Current	
Infrastructure			Current		

CIO Office

Current Allocation

Previous Allocation

Market Review

Fixed Income

- Two rate cuts in two weeks by the FOMC brought the Federal Reserve's policy rate down 150 bps and resting against the zero-lower bound.
- Revenue streams drying up amid the coronavirus-induced global pause pushed investors and businesses alike toward Treasuries and cash.
- High-yield and investment-grade bond spreads climbed sharply as the risk of defaults shot up amid such widespread uncertainty.

Canadian Equities

- The S&P/TSX suffered its worst monthly performance since 1998, dragged down by both a halt in global economic activity, and plunging commodity prices.
- Case in point: Energy – which represents approximately 17% of the index by weight – was this month's worst performer, losing nearly a third of its value over the period.

U.S. Equities

- A record long bull run ended abruptly for U.S. equities in March, as the S&P 500 fell into bear market territory at record speed.
- The first quarter of 2020 had started on a positive note; a newly minted "Phase One" trade deal between the U.S. and China had recently been signed, and corporate earnings looked set to rebound.
- However, the fast spread of COVID-19 and accompanying quarantine measures brought most economies to a standstill and sent proxy measures of uncertainty such as the CBOE VIX Index skyrocketing.
- Drastic fiscal and monetary policy measures announced late in the month did pave the way for a "modest" S&P 500 rebound, closing out the period 15.5% up from its March 23 lows but still in bear market territory.

Commodities

- Just as global demand for oil was drying up due to the ongoing pandemic, OPEC+ members failed to reach an agreement, driving Saudi Arabia and Russia to engage in an all-out price war.
- The double whammy of a collapse in demand and an upsurge in the supply of oil has brought WTI prices down nearly 55% in just one month to levels last seen in 2002.
- As for Gold, the lustrous metal has failed to shine as a safe haven asset, gaining just 1.6% by the end of March, but having swung by nearly $200/ounce during this same time.

Foreign Exchange

- A scramble for cold hard cash by investors and companies squeezed the Greenback nearly 5% higher by mid-March.
- News of unlimited QE and other types of liquidity injections by the Federal Reserve helped relieve some of this pressure.
- Meanwhile, faced with tumbling Energy and Commodity prices, the Loonie depreciated to 2016 levels in its worst monthly performance since January 2015.

Table 2 Market Total Returns

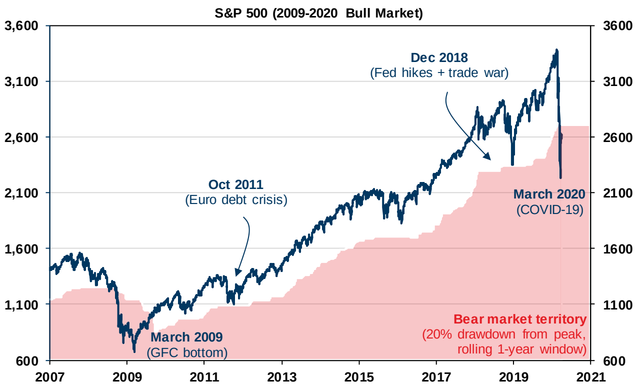
Asset Classes	March	Q1	12 months
Cash (3-month T-bills)	0.3%	0.7%	1.9%
Bonds (FTSE CA Ovr. Univ.)	**-2.0%**	**1.6%**	**4.5%**
FTSE CA Short term	0.1%	1.8%	3.2%
FTSE CA Mid term	-0.4%	3.3%	5.3%
FTSE CA Long term	-5.5%	0.2%	5.6%
FTSE CA Government	-0.7%	3.1%	5.6%
Federal	1.6%	5.1%	6.4%
Provincial	-2.8%	1.3%	5.0%
Municipal	-2.6%	1.2%	5.0%
FTSE CA Corporate	-5.4%	-2.5%	1.3%
AA+	-1.6%	0.3%	2.4%
A	-5.5%	-2.2%	2.5%
BBB	-7.3%	-4.2%	0.0%
BoAML High-Yield (USD)	-11.7%	-13.1%	-7.4%
Preferred Shares	-20.1%	-22.8%	-21.0%
Canadian Equities (S&P/TSX)	**-17.4%**	**-20.9%**	**-14.2%**
Energy	-30.8%	-37.2%	-33.9%
Industrials	-13.3%	-15.0%	-7.5%
Financials	-18.3%	-21.1%	-13.3%
Materials	-10.0%	-18.8%	-7.3%
Utilities	-9.7%	-5.3%	12.2%
Cons. Disc	-25.7%	-32.8%	-29.5%
Cons. Staples	-7.6%	-9.3%	-6.2%
Healthcare	-22.6%	-37.1%	-62.4%
IT	-9.7%	-3.7%	26.1%
Comm. Svc.	-4.2%	-8.1%	-5.6%
REITs	-29.3%	-28.4%	-25.3%
S&P/TSX Small Cap	-29.3%	-38.1%	-35.2%
US Equities (S&P500 USD)	**-12.4%**	**-19.6%**	**-7.0%**
Energy	-34.8%	-50.5%	-52.4%
Industrials	-19.2%	-27.0%	-19.5%
Financials	-21.3%	-31.9%	-17.1%
Materials	-14.1%	-26.1%	-16.6%
Utilities	-10.0%	-13.5%	-1.4%
Cons. Disc	-13.2%	-19.3%	-10.8%
Cons. Staples	-5.4%	-12.7%	-0.6%
Healthcare	-3.8%	-12.7%	-1.0%
IT	-8.6%	-11.9%	10.4%
Comm. Svc.	-12.1%	-17.0%	-3.3%
REITs	-14.9%	-19.2%	-11.3%
Russell 2000 (USD)	-21.9%	-30.9%	-25.1%
World Eq. (MSCI ACWI)	**-13.4%**	**-21.3%**	**-10.8%**
MSCI EAFE (USD)	-13.2%	-22.7%	-13.9%
MSCI EM (USD)	-15.4%	-23.6%	-17.4%
Commodities (CRB index)	**-6.3%**	**-7.8%**	**-13.0%**
WTI Oil (US$/barrel)	-56.5%	-66.5%	-65.9%
Gold (US$/ounce)	1.6%	6.0%	24.4%
Copper (US$/tonne)	-12.1%	-19.7%	-23.9%
Forex (DXY - US Dollar index)	**0.9%**	**2.8%**	**1.8%**
USD per EUR	-0.1%	-2.2%	-2.3%
CAD per USD	4.9%	8.3%	5.4%

CIO Office (data via Refinitiv) 2020-03-31

Down in History

After a run of 11 years (almost to the day), the S&P 500 bull market came to an abrupt end in March, as a rapidly evolving pandemic forced governments around the world to pull the emergency brake on their respective economies in an unprecedented fashion (Chart 1).

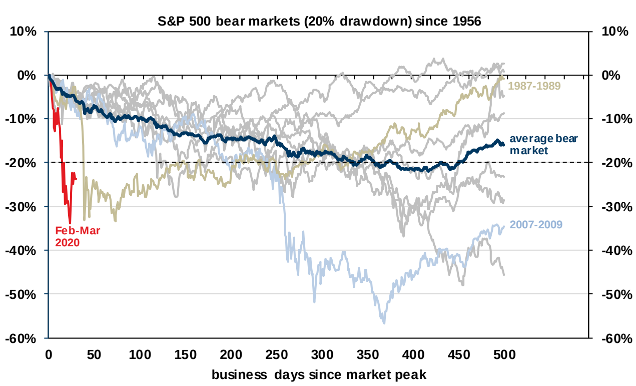
1 The 11-year-old S&P 500 bull market came to an end...



CIO Office (data via Refinitiv).

To give a sense of the exceptional nature of what markets are going through: U.S. equities' plunge into bear market territory was their fastest in history (Chart 2), while the level of volatility recently witnessed compares only to that of the 1987 crash and the Great Depression (Chart 3).

2 ... at an unprecedented speed...

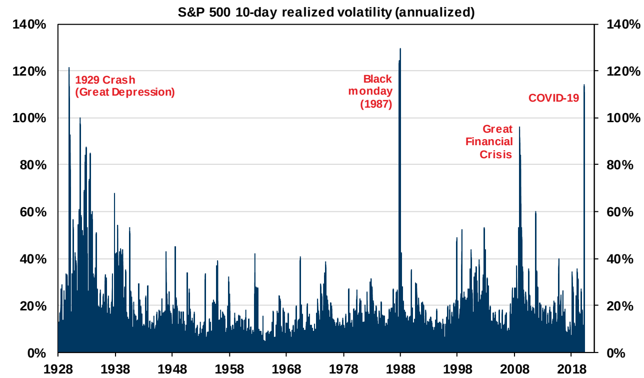


CIO Office (data via Refinitiv).

Such remarkable market action reflects the seriousness and highly unpredictable nature of the ongoing global health crisis which has sent hundreds of millions of workers – including market participants and liquidity providers – home almost overnight. But what now? Should we further reduce our equity allocation, having gone to neutral early in the crisis? Or, should we take advantage of the stock market downturn in anticipation of a rebound?

Tactical asset allocation is never easy, and today is certainly no exception. However, these kinds of situations are precisely what investment processes were made for. In our case, it always begins with an assessment of the four pillars of asset allocation, namely (1) investors' sentiment, (2) valuations, (3) monetary conditions, and (4) global growth – as summarized below.

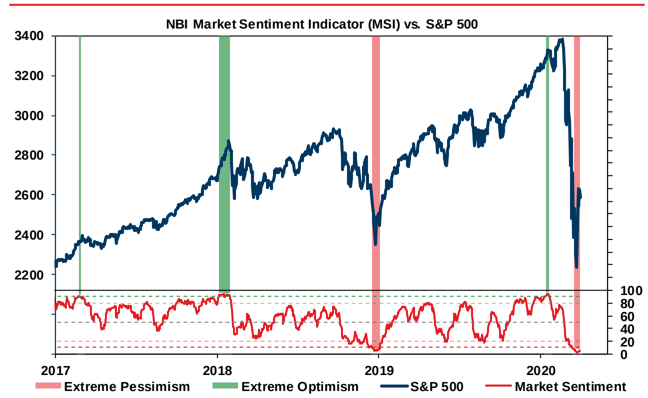
3 ... and amid exceptionally high volatility



CIO Office (data via Refinitiv, Bloomberg).

The first one – investors' sentiment – is straightforward: it's extremely low. Our Market Sentiment Indicator (MSI) reached "extreme pessimism" levels on March 16 (i.e. when the S&P 500 reached 2386, or 30% below its February 19 peak) (Chart 4). In and of itself, this suggested a strong likelihood of a rebound in stock prices. That's indeed what we ultimately saw in the two weeks that followed (the S&P 500 closed March at 2586), but that doesn't necessarily mean we're out of the woods. Case in point: a look back at 2008/2009 shows that it is common to see technical rebounds during bear markets, but these are often very short-lived (Chart 5, next page).

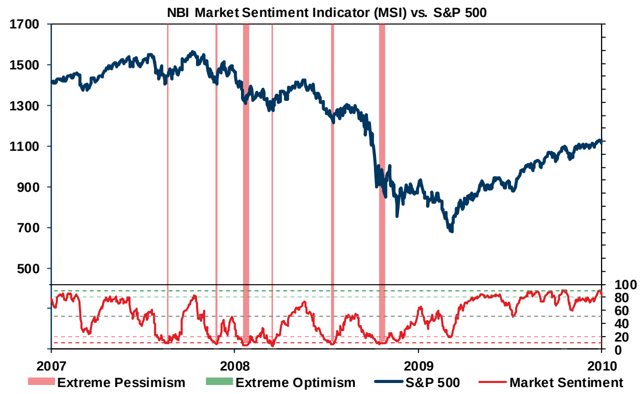
4 Extremely low market sentiment suggest a rebound...



CIO Office (data via Refinitiv).

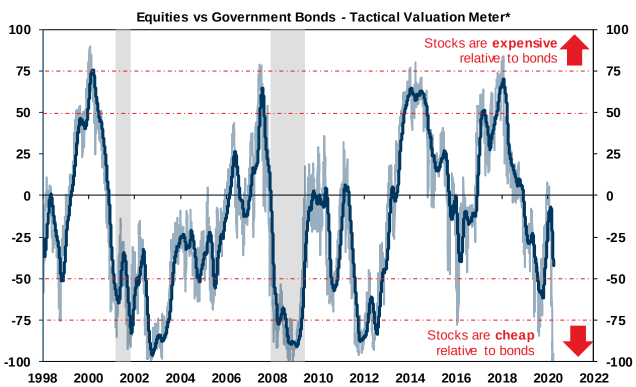
The second one – valuations – has moved dramatically in the last few weeks. With government bond yields and price-earnings ratios falling, our Tactical Stocks/Bonds Valuation Meter – which has been quite reliable at signalling conditions prone to major turnarounds over the last two decades – is increasingly advocating in favour of equities. However, it will likely take a few more weeks for the smoothed gauge to provide a more compelling signal (Chart 6, next page).

5 … but that doesn't mean we're out of the woods



CIO Office (data via Refinitiv).

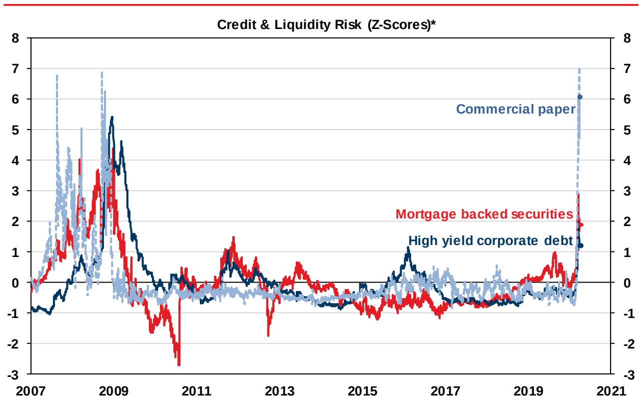
6 Valuations increasingly advocating in favour of equities



CIO Office (data via Refinitiv). *Spread between the average percentile rank of S&P 500, S&P/TSX, MSCI EM, MSCI EAFE PE ratios and US/CA 10-year Treasury yields. 3-year rolling window. Dark line = 60-day moving average. Pale line = 10-day moving average.

The third one – monetary conditions – requires a deeper dive. Various measures of credit and liquidity have been under a lot of stress lately, raising fears that the health crisis could morph into another financial crisis (Chart 7).

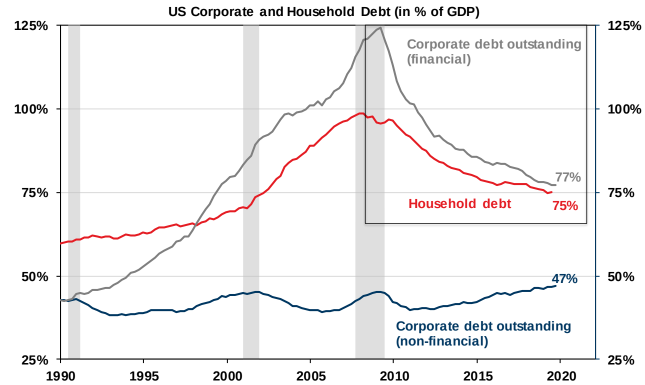
7 Credit and liquidity are under great pressure…



CIO Office (data via Refinitiv). As of March 30. *Commercial paper = US AA non-financial 3m spread to 3m t-bills. Mortgage backed securities = ICE BofA US FNMA 30-Year MBS Index OAS. High yield = ICE BofA US High Yield Index spread to 10-year treasuries.

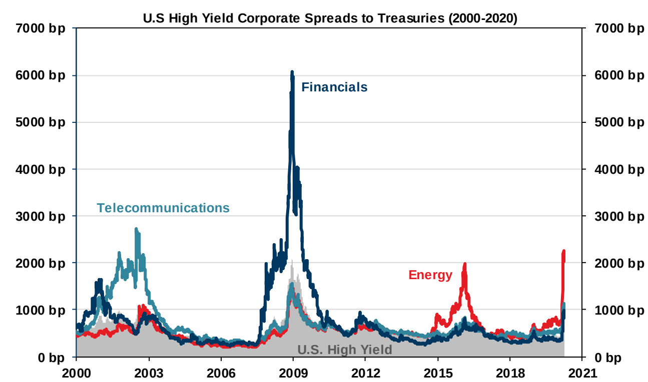
These concerns are legitimate, but unlikely to materialize. A key reason is that the 2008/2009 pre-existing conditions (excessive leverage in the banking sectors and households) are no longer present today (Chart 8). Thus, the Achilles' heel of credit markets is not the financial sector this time, but the energy sector, courtesy of Saudi Arabia's oil price war (Chart 9).

8 … but this is not a repeat of the financial crisis



CIO Office (data via Refinitiv).

9 Credit markets Achilles' heel: Energy

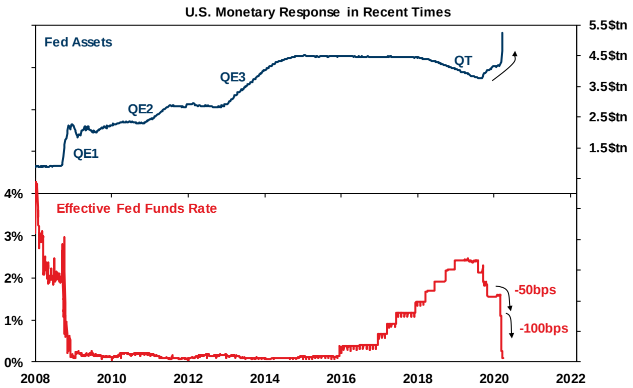


CIO Office (data via Refinitiv).

Still, we must recognize that leverage of non-financial corporations (blue line in chart 8) has steadily increased over the past decade. While such indebtedness is arguably sustainable when revenue fluctuations are subject to the usual economic ups-and-downs, one need not be an economist to understand that it can quickly cause problems when several companies are suddenly deprived of revenue for exceptional public health reasons.

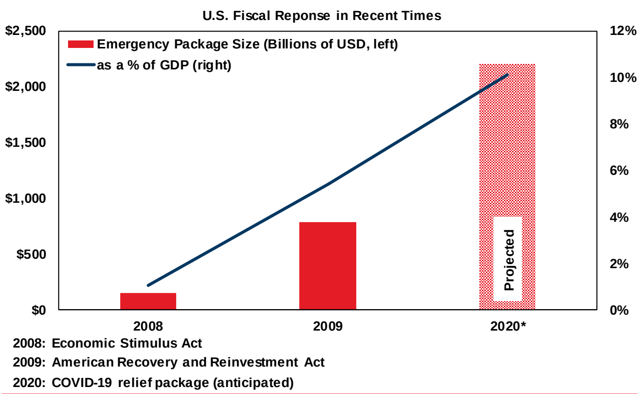
Thankfully, these extraordinary times have elicited extraordinary measures from both central banks and governments across the globe. Specifically, in the U.S., the Federal Reserve has slashed its policy rate by 150 basis points all the way down to the 0%-0.25% range and launched unlimited quantitative easing in the space of just one month (Chart 10, next page). Perhaps most importantly, it essentially pledged to backstop mortgage-backed securities, municipal debt, commercial paper, investment-grade corporate bonds, and even direct lending for small businesses. For its part, Washington has announced a 2 trillion USD fiscal plan, the most ambitious ever proposed in U.S. history (Chart 11, next page).

10 Extraordinary times → extraordinary monetary...



CIO Office (data via Refinitiv).

11 **... and fiscal measures**



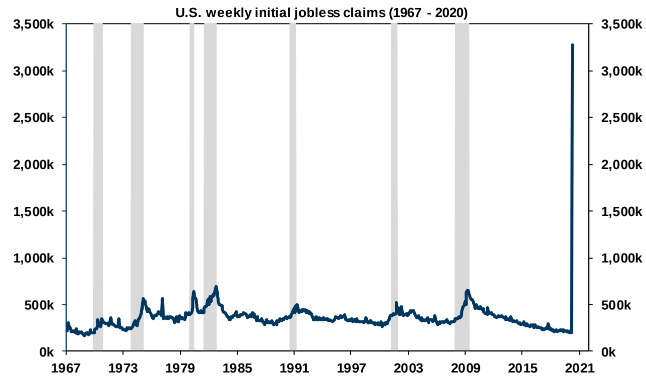
CIO Office (Data via Refinitiv, U.S. Congressional Business Offic) *GDP figure as of 2019

The size of these actions may lead some to question the consequences for public finances and the role of central banks. There will indeed be a before-and-after to this crisis. Yet, keep in mind that the main objective here isn't to "stimulate" the economy but to "save" it from suffering permanent damage until the temporary containment measures we have collectively self-imposed do their job. That is why we welcome the remarkable pro-activity of the monetary and fiscal authorities, which has stopped the bleeding in credit markets and should allow for a sustained recovery once the crisis is behind us.

So, if we summarize up to now: investor sentiment is extremely pessimistic, stock valuations are depressed relative to government bonds, and monetary and fiscal conditions are highly accommodative – all of which argue in favour of equities. Are we therefore bullish?

Well, we're missing the last pillar – global growth – and this one is in recession. Never in history has the world been hit by such a broad, deep, and sudden economic shock. Consequently, many economic figures will go where they have never gone before over the coming weeks and months – the recent jobless claims numbers being a good example (Chart 12). While difficult to foresee with any degree of accuracy what the economic growth will be under such circumstances, there is little doubt

12 Initial jobless claims: unprecedented

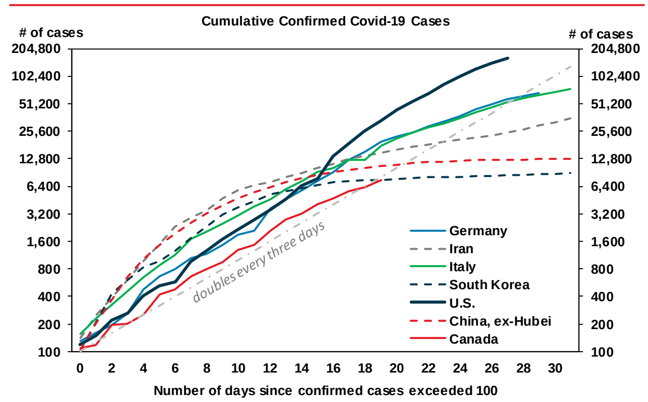


CIO Office (data via Refinitiv).

that we are beginning what will be the weakest quarter for GDP growth ever recorded.

Now, what are we to conclude from all this? Simply put, for investor sentiment to strengthen, equity valuations to recover, monetary and fiscal conditions to gain full traction, and global growth to bottom out, the root problem of all of this turmoil must subside. That is, COVID-19's exponential propagation must be slowed down. Encouragingly, the situation remains under control in Asia and appears to be stabilizing in Italy. But, it is deteriorating considerably in the United States where the number of new cases continues to grow faster and higher than anywhere else (Chart 13).

13 Worrisome trajectory in the U.S.



CIO Office (data via John Hopkins University).

As such, while conditions are lining up for a stock market rebound ahead of an economic restart, the overall situation remains precarious and still calls for caution in the short-term – hence why we remain neutral on equities with extra cash on hand. (See our *checklist* of key elements to observe before turning more optimistic in Chart 14, next page).

14 Key elements to observe before turning more optimistic

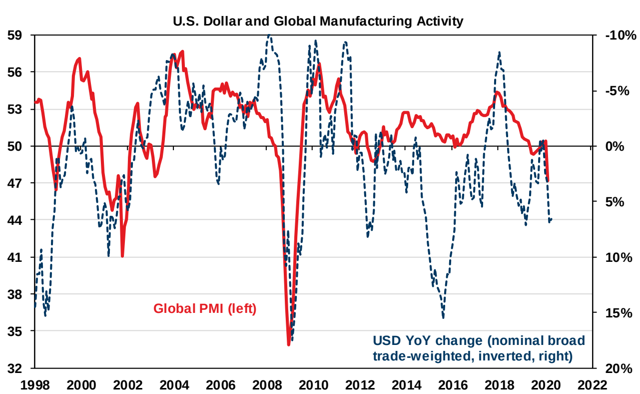
✔	Concrete fiscal measures to help workers and businesses
-	The flow of credit to be restored to households and businesses
-	The stock market to consolidate around current levels
X	A slowdown in the growth rate of new COVID-19 cases worldwide
X	Clearer crude oil supply-and-demand fundamentals

CIO Office

Currencies: The Almighty USD

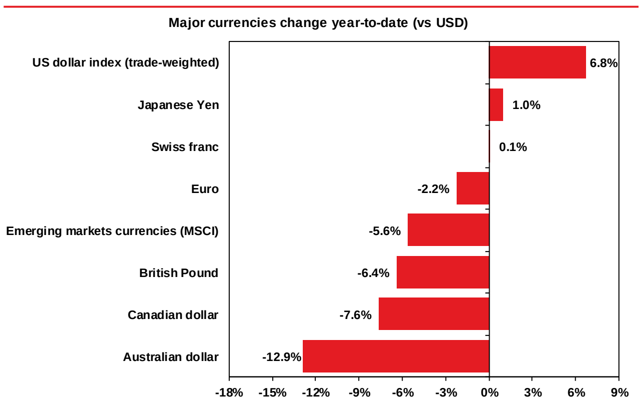
Consistent with its counter-cyclical habits (Chart 15), the U.S. dollar has appreciated sharply over the past month, sparing only the Swiss franc and the Japanese Yen – other safe haven of choice in times of turmoil (Chart 16).

15 ↓ Global growth = ↑ U.S. dollar



CIO Office (data via Refinitiv).

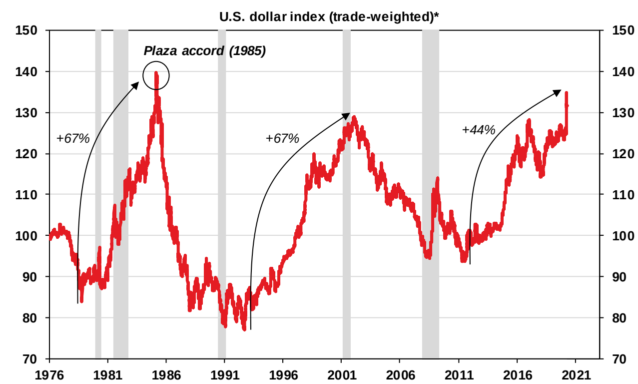
16 The almighty dollar shines so far this year...



CIO Office (data via Refinitiv).

While such movement in the FX space isn't surprising, it also isn't inconsequential. As the U.S. dollar rises, it effectively tightens global financial conditions – a threat to the numerous foreign borrowers (companies but also developing countries) who carry significant USD-denominated liabilities. Luckily, recent action taken by the Federal Reserve and improving risk appetite eased the pressure on the Greenback late in March. Yet, if the uptrend were to resume and jeopardize the stability of the world economy, we wouldn't be surprised to see a multi-country agreement explicitly aimed at devaluing the U.S. dollar along the lines of the 1985 Plaza Agreement (Chart 17). We're not there yet and may never need to be. However, it's certainly something we'll be following closely in the coming weeks as it would have far-reaching consequences (notably for geographical leadership and gold prices as discussed briefly in the Equities and Commodities sections, respectively).

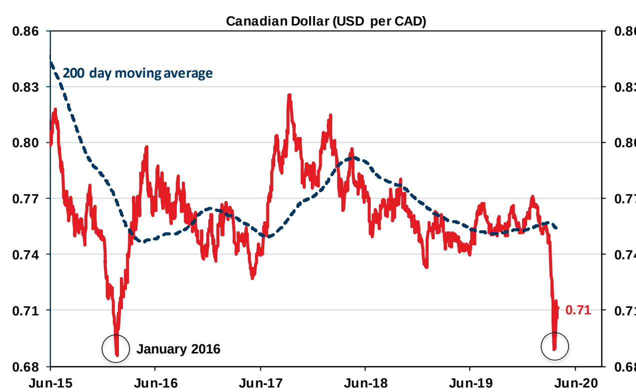
17 ...but for how much longer?



CIO Office (data via Refinitiv). *US nominal major index from 1976 to 1993 (Fed), broad index onwards (JPM NEER).

Closer to home, the Loonie has also behaved typically, which is to decline in times of market turmoil. At one point, the Canadian dollar was down an impressive 11% from its early-year peak – bringing the currency almost exactly to its January 2016 low (Chart 18).

18 2016 all over again? We doubt it.

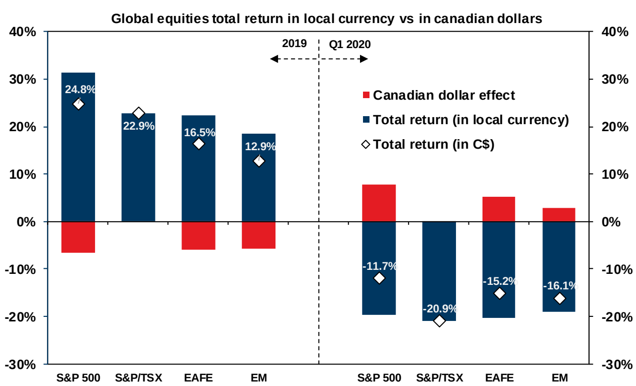


CIO Office (data via Refinitiv).

Does this mean that a repeat of the spectacular rebound we saw in 2016 is set to unfold in the coming weeks? We doubt it. Given the bleak outlook for global growth, the ongoing oil price war, and the fact that both the Bank of Canada and the Federal Reserve are almost certain to keep their monetary policy unchanged in the near future (with not only zero target rates but also asset purchase programs, a first in Canada), a sharp rise in the Loonie is hardly conceivable. Incidentally, our colleagues from NBF Economics and Strategy have revised their USD/CAD projection for Q3 to 1.46 (~0.685 CAD/USD).

In any case, let's not forget that investors generally get most of their U.S. dollar exposure through foreign equities. As such, simply letting the currency fluctuate – as we've often recommended – usually results in a positive diversification effect when foreign equity returns are brought back to our side of the border. Granted, performances won't be as outstanding when the stock market soars, but the inevitable downturns will typically be less severe – and Q1 2020 is a case in point (Chart 19).

19 The loonie fulfills its diversification role



CIO Office (data via Refinitiv).

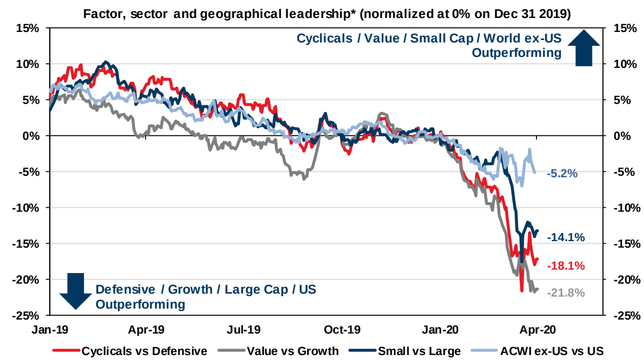
Equities: In the Eye of the Storm

The storm which equity markets are going through has revived several trends that characterized much of the last year (and decade, in some cases). Specifically, defensive, growth, large, and U.S. equities have all surpassed their cyclical, value, small, and foreign (World ex-U.S.) relatives so far this year (Chart 20).

As one can infer, the direction of these highly correlated trends is very much dependent on investor risk appetite and global growth prospects. With both falling sharply, markets favoured companies operating in more stable sectors (defensive) which can expect to grow despite the economic downturn (growth) and with generally stronger balance sheets (large caps) – all of which are over-represented in the U.S.

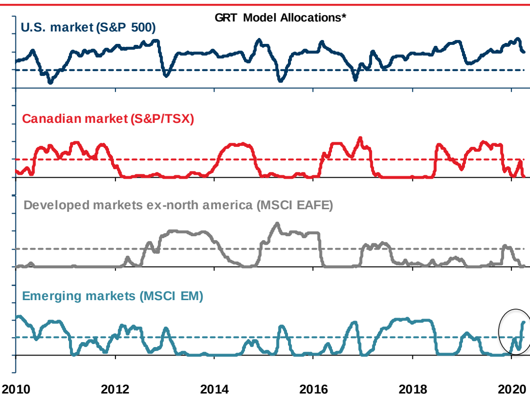
Accordingly, a sharp and sustained reversal of these trends is unlikely to occur until investor risk appetite and global growth prospects improve. But when such time comes, we will likely be looking to increase our allocation in emerging markets (EMs). In fact, our GRT model – whose objective is to translate relative trends into allocation recommendations among the four main equity regions – has already moved in favour of EMs in recent weeks (Chart 21).

20 The storm has revived several trends in equity markets



CIO Office (data via Refinitiv). *Cyclicals vs Defensive = U.S. Energy/materials/industrials/financials, vs Staples/Tech/Utilities/Comm.Serv. Value vs Growth = S&P 500 Pure value vs Pure growth. Small vs Large = Russell 2000 vs S&P 100. ACWI ex-US vs US = ACWX vs SPY.

21 **A positive signal stands out in EM (in local currency)...**



CIO Office (data via Refinitiv). *Equal weight benchmark. Dashed line = neutral. Relative trends are measured with local currency indices.

If the U.S. dollar heads down in the coming months, effectively easing global financial conditions, reducing borrowing costs for many EM corporations, and influencing capital to flow in faster-growing economies, this could trigger a period of leadership for emerging markets as has historically been the case under such conditions (Chart 22, next page). Again, we're not there yet and the precariousness of the current situation incites us to err on the side of caution, but it's something we'll be watching closely in the coming weeks.

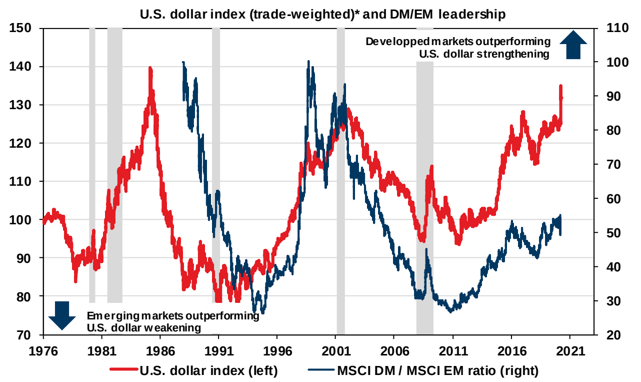
Commodities: Profound Uncertainty

Crude oil prices completely collapsed in March, as the combination of falling demand (from the COVID-19 induced economic downturn) and rising supply (following a breakdown in OPEC+ negotiations) delivered a KO, one-two punch to the commodity (Chart 23, next page).

For more details on this matter, we strongly recommend that you consult our just-published Strategic Report – *Crude Awakening: The 2020 Oil Price Collapse* – where we discuss the whys and wherefores of the ongoing price war on energy markets.

In short, the key conclusion is that we advise caution in taking positions in financial assets tied to energy prices. While they

22 ... but its sustainability depends largely on the U.S. dollar



CIO Office (data via Refinitiv). *US nominal major index from 1976 to 1993 (Fed), broad index onwards (JPM NEER).

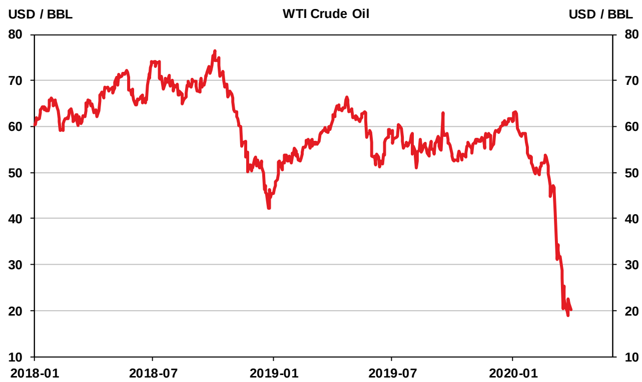
24 A 100 million barrels per day ecosystem

Petroleum (& Other Liquids) World supply and Demand (in Million Barrels per Day)

Year	2013	2014	2015	2016	2017	2018	2019
OECD Supply	24.0	26.1	27.2	26.9	27.7	30.2	31.6
ex-OECD Supply	67.6	68.2	69.9	70.7	70.4	70.6	69.0
World Supply	91.7	94.2	97.1	97.6	98.1	100.8	100.6
OECD Demand	45.9	45.7	46.5	46.9	47.4	47.6	47.4
ex-OECD Demand	46.4	48.2	49.2	49.9	51.3	52.3	53.4
World Demand	92.3	93.9	95.7	96.8	98.7	100.0	100.8
World Surplus / Deficit	(0.6)	0.3	1.4	0.8	(0.6)	0.8	(0.2)
OPEC Supply	35.1	35.2	36.4	37.5	37.4	37.3	35.2
Canada Supply	4.1	4.4	4.5	4.6	5.0	5.4	5.5
US Supply	12.4	14.1	15.1	14.8	15.7	17.9	19.5
China Demand	11.1	11.6	12.5	13.0	13.6	14.0	14.5

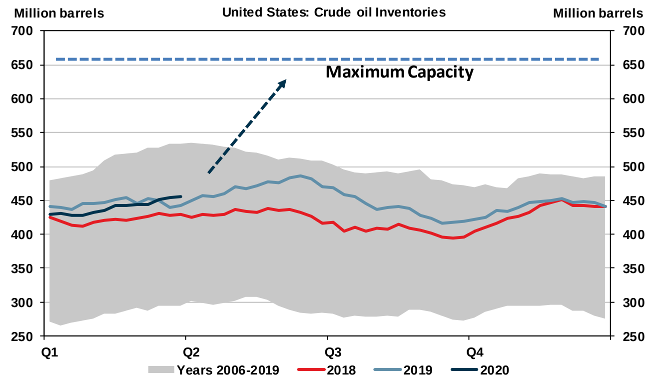
CIO Office (Source: EIA, data via Refinitiv)

23 Crude oil prices collapsed in March



CIO Office (data via Refinitiv).

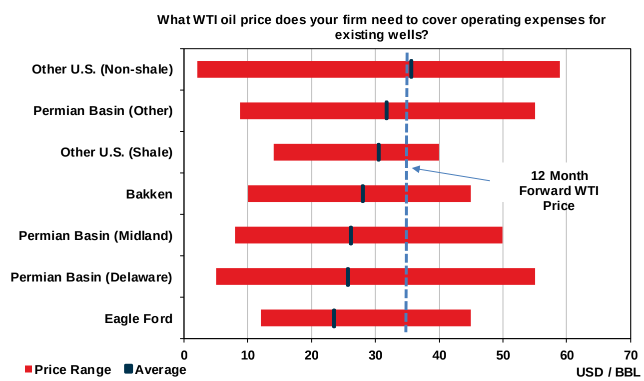
25 Inventory capacity could be tested



CIO Office (data via Refinitiv).

trade near historic lows, the situation may remain problematic for some time and even deteriorate before the inevitable rebound takes place. Granted, soon-to-be-announced government actions may ease financial stress on many companies. However, the magnitude of the imbalance (estimated at between 10 and 20 MBPJ in an ecosystem of about 100 MBPJ, Chart 24) suggests that storage capacity could be tested (Chart 25) and that the energy industry must undergo some rationalization (Chart 26). Consequently, while the unsustainability of the situation ultimately points to higher prices, we are lowering our outlook for crude oil a notch due to near-term uncertainty. The same goes for base materials, which should remain under pressure for as long as the global economy remains sluggish.[1]

26 Rationalization is in the cards



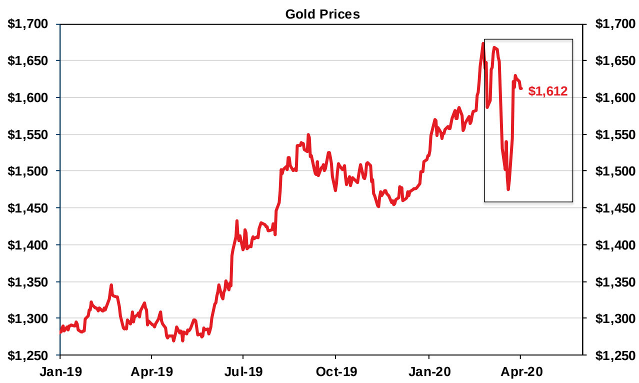
CIO Office (data via Refinitiv, Dallas Fed).

Turning to gold prices, these have been stirred up in every direction over the past month, ending the period not far from where they began (Chart 27, next page). Yet, shouldn't the price of this safe haven have soared amid such uncertain times?

Not necessarily. Some of our readers may recall our July 2019 monthly report where we reviewed the two key macroeconomic drivers of gold prices, namely U.S. real yields (gold's opportunity cost, Chart 28, next page) and the U.S. dollar (gold shares many of the characteristics of currency after all, Chart 29, next page). Back then, we mentioned that a recession could actually weigh on the bullion, as it typically drives inflation to the ground (i.e. real yields higher) and spurs the Greenback (partly due to the

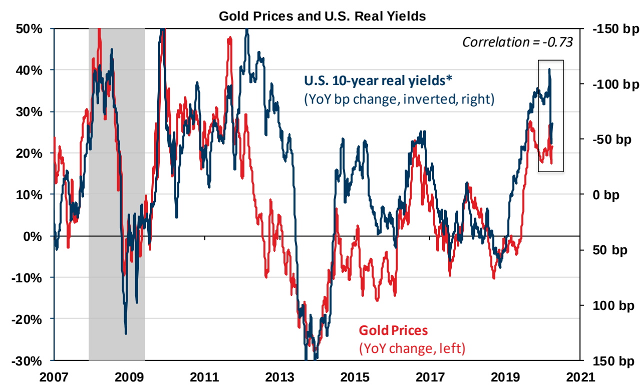
[1] Please note that we will be reviewing the way we communicate our global asset allocation views (table 1) in the months to come.

27 What's up with gold?...



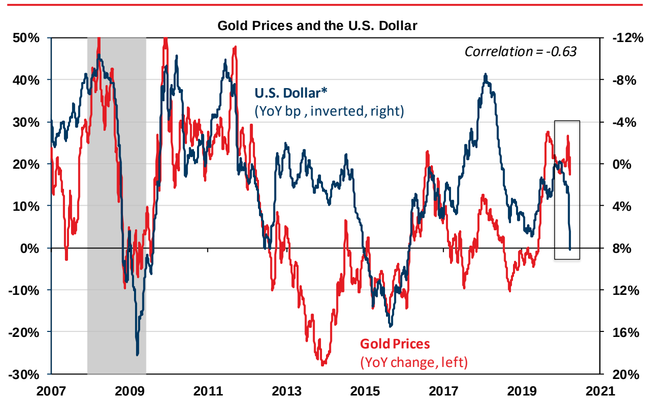
CIO Office (data via Refinitiv).

28 **... it's a matter of real yields...**



CIO Office (data via Refinitiv).

29 **... and of U.S. dollar**

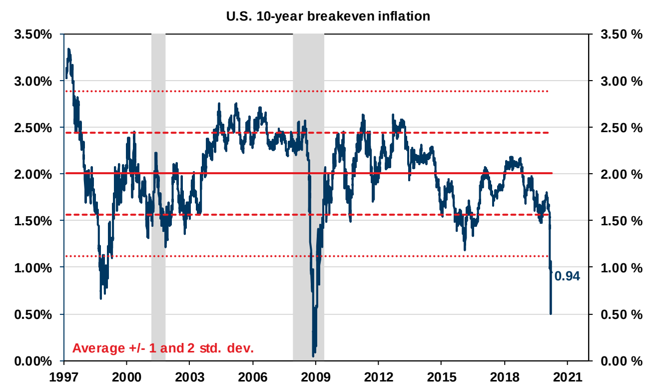


CIO Office (data via Refinitiv).

high demand for liquidity). That is indeed what happened during the financial crisis – gold prices were flat year-over-year when equities bottomed in March 2009 – and, again, this past month.

Now, does this mean that investors should avoid gold? Not at all. With central banks pledging their balance sheets to ensure sufficient liquidity and low nominal yields in addition to their clear incentive to put a cap on U.S. dollar strength, gold could fare relatively well should inflation expectations – near their lowest levels since 2009 (Chart 30) – recover over the coming year. In fact, this is precisely what happened during the post-financial crisis rebound, with bullion rising ~25% between March 2009 and 2010. While much uncertainty remains in the short-term, the risk/reward characteristics of yellow metal over the next twelve months are rather supportive.

30 **'Expected' inflation should recover over the next year**

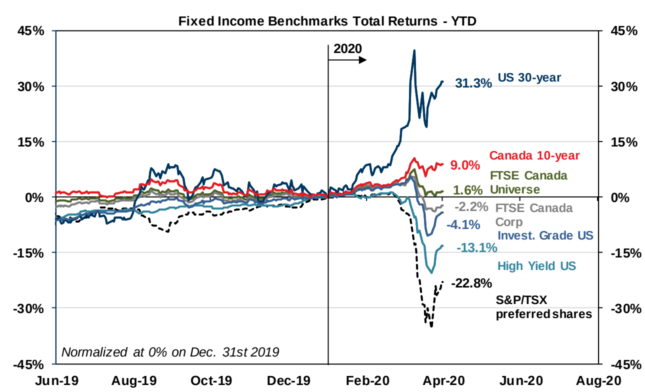


CIO Office (data via Refinitiv).

Fixed Income: Shock Wave

The ongoing economic earthquake created a shock wave in the fixed-income market, sending long-duration Treasury bonds through the roof and lower grade assets to the ground (Chart 31).

31 Shock wave in the fixed-income market

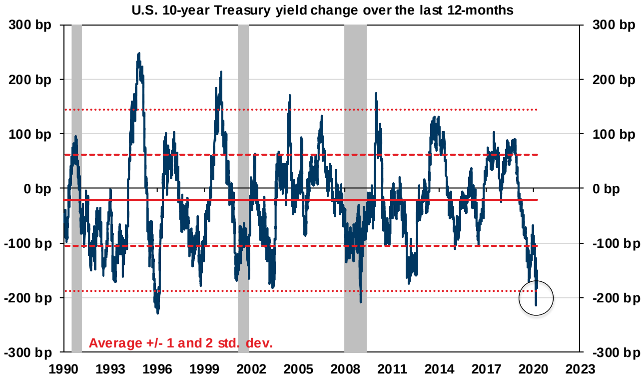


CIO Office (data via Refinitiv).

At current levels, the incremental return potential for government debt securities seems fairly limited – even in the event of another wave of risk aversion – given how far U.S. 10-year Treasury yields have travelled over the last 12 months (Chart 32, next page).

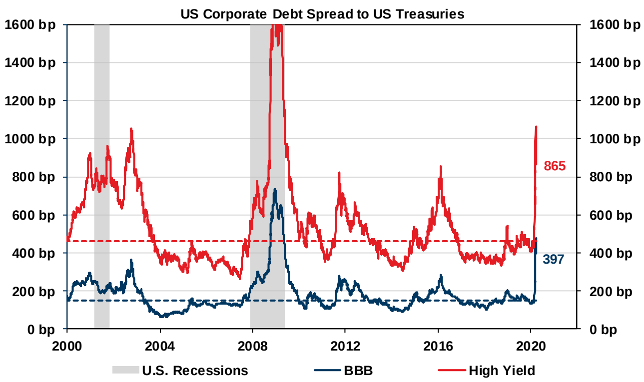
On the other hand, some value opportunities are undoubtedly found in the credit market, which should see their spreads narrow as things improve over the course of the year (Chart 33, next page). For now, we recommend that investors focus their

32 10-year yields have already travelled a long way



CIO Office (data via Refinitiv).

33 Attractive valuations but quality is of the essence



CIO Office (data via Refinitiv).

shopping on investment-grade securities considering that the Federal Reserve has essentially committed to protect quality issuers from default – a left-tail risk that remains conceivable in the high-yield universe that is comprised of many energy companies.

CIO Office

CIO-Office@nbc.ca

Martin Lefebvre
CIO and Strategist
martin.lefebvre@nbc.ca

Simon-Carl Dunberry
Chief Analyst
simon-carl.dunberry@nbc.ca

Louis Lajoie
Principal Analyst
louis.lajoie@nbc.ca

Nicolas Charlton
Analyst
nicolas.charlton@nbc.ca

General

The present document was prepared by National Bank Investments Inc. (NBI), a wholly owned subsidiary of National Bank of Canada. National Bank of Canada is a public company listed on the Toronto Stock Exchange (NA: TSX).

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. The opinions are not intended as investment advice nor are they provided to promote any particular investments and should in no way form the basis for your investment decisions. National Bank Investments Inc. has taken the necessary measures to ensure the quality and accuracy of the information contained herein at the time of publication. It does not, however, guarantee that the information is accurate or complete, and this communication creates no legal or contractual obligation on the part of National Bank Investments Inc.

NBI or its affiliates often act as financial advisor, agent or underwriter for certain issuers mentioned herein and may receive remuneration for its services. As well NBI and its affiliates and/or their officers, directors, representatives, associates, may have a position in the securities mentioned herein and may make purchases and/or sales of these securities from time to time in the open market or otherwise.

This document is for distribution only under such circumstances in Canada and to residents of Canada as may be permitted by applicable law. This document is not directed at you if NBI or any affiliate distributing this document is prohibited or restricted by any legislation or regulation in any jurisdiction from making it available to you. You should satisfy yourself before reading it that NBI is permitted to provide this document to you under relevant legislation and regulations.

Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments (the "Funds"). Please read the prospectus of the Funds before investing. The Funds' securities are not insured by the Canada Deposit Insurance Corporation or by any other government deposit insurer. The Funds are not guaranteed, their values change frequently and past performance may not be repeated.