



INVESTING

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Asset Allocation Strategy

Let the year start in February

MARTIN LEFEBVRE

Chief investment strategist
(514) 412-8572
martin.lefebvre@bnc.ca

Market review

January was as volatile as it could be, with the S&P 500 index gyrating widely up and down throughout the month, for a total loss of 3%. While things started on shaky grounds for last year's top performing developed market, risk-off was not the general tone for equities in January. EAFE markets performed particularly well, buoyed by a weaker euro and the launch of a better-than-expected quantitative easing program by the European Central Bank (ECB) in response to slowing growth and deflation worries. Canadian equities managed to finish the month with a positive return, thanks to a strong performance by gold miners that was partly offset by the energy sector. The latter continues also to hurt the Canadian dollar which fell nearly 10% in January, also due in part to a surprise rate cut by the Bank of Canada. Meanwhile, the rally in fixed income securities continued, with U.S. 10-year yields falling nearly 50 basis points to 1.68%, the lowest level since 2013. This drove up gold prices which reached US\$1,300 during the month.

Asset allocation strategy

- In the short-term, we are playing it safe by maintaining an overweight position in the U.S. large-cap equity market, which should continue to benefit from a lower relative beta and ongoing improvement in the global economy, and which offers a better exposure to our favorite sector, information technology.
- Over the longer run, we think the EAFE region, and particularly Continental Europe, shows the most upside potential. The lower euro, combined with massive liquidity injections from the ECB all but guarantee that risk assets will outperform. As European stocks look historically cheap on both a relative and absolute basis, there could be a timing opportunity to slowly increase EAFE exposure to overweight.
- Ultra-loose global monetary policy and falling energy prices could keep pushing long-term bond yields lower. However, if energy prices stabilize at current levels, the downtrend in inflation will likely reverse around July. Nevertheless, fixed income securities bought at a premium almost guarantee that your after-tax real return will be negative.

Table 1 Market total returns

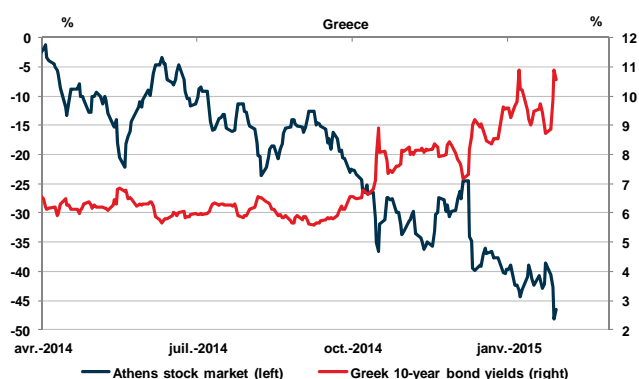
Asset classes	YTD	2014	2013
Cash (3-month T-bills)	0,1%	0,9%	1,0%
Bonds (Dex Overall Universe)	4,6%	8,8%	-1,2%
Dex Overall Federal	4,0%	6,9%	-1,5%
Dex Overall Corporate	3,6%	7,6%	0,8%
Dex BBB	3,8%	9,0%	1,2%
BoAML High-Yield (USD)	0,7%	2,5%	7,4%
World equity MSCI (USD)	-1,5%	4,7%	23,4%
S&P/TSX	0,5%	10,6%	13,0%
S&P/TSX Small cap	0,5%	-2,3%	7,6%
S&P500 (USD)	-3,0%	13,7%	32,4%
Russell 2000 (USD)	-3,3%	3,5%	37,0%
MSCI EAFE (USD)	0,5%	-4,5%	23,3%
MSCI EM (USD)	0,6%	-1,8%	-2,3%
Commodities (CRB index)	-3,5%	-4,1%	-5,7%
WTI oil (US\$/barrel)	-11,5%	-45,4%	7,3%
Gold (US\$/ounce)	7,3%	-1,8%	-27,3%
Copper (US\$/tonne)	-13,0%	-13,7%	-6,7%
Forex (JPM US Dollar index)	3,5%	10,0%	3,7%
USD per EUR	-6,7%	-12,2%	4,5%
JPY per USD	-1,9%	13,7%	21,4%
CAD per USD	9,6%	9,4%	7,1%

Source: Datastream

* 2015-01-30

CHART OF THE MONTH

Markets cautious on Greece



1 Source: Datastream



Will risks linked to Greece 2.0 ...

Fed up with austerity measures, on January 25th the Greek people elected a new government whose primary goal is to renegotiate the bailout terms with its lenders. This will not be easy. Germany, which carries the most weight in the Troika (the ECB, the European Commission and the International Monetary Fund), is strongly against renegotiation, and financial markets will not be complacent about the situation (chart of the month).

But Greece has nothing to loose. Austerity measures are hurting economic growth and the country's debt-to-GDP ratio keeps rising even as the former government has drastically cut spending over the past couple of years. Therefore, while debt obligations are unlikely to be reduced, it is in everyone's interest to renegotiate the terms of the agreement and make sure Greece remains in the eurozone.

... be offset by the ECB?

Some might call it a perfect timing, but after pledging in July 2012 that he would do "whatever it takes" to maintain the integrity of the euro, in January 2015 ECB's Mario Draghi once again took action with the launch of a bigger-than-expected quantitative-easing (QE) program. In short, the ECB will buy a total of €60 billion worth of bonds per month, including, for the first time, sovereign and investment grade corporate debt securities. While the ECB intends to pursue these purchases through September 2016, it won't stop the program until a sustained adjustment in the path of inflation is observed. This open-ended large-scale QE program was well received by markets, and may again prove to be a game changer for Europe.

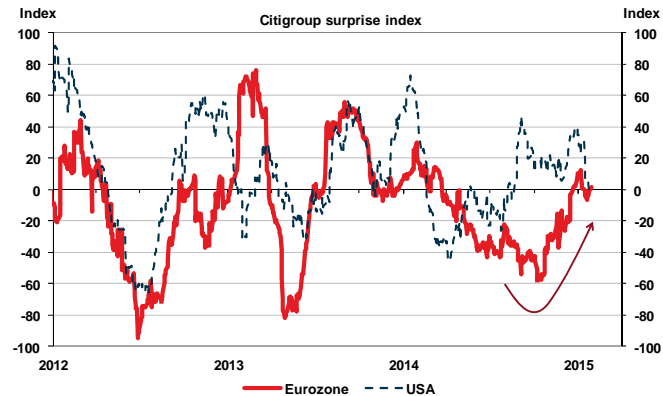
This comes at a very good time since the growth worries of late 2014, which prompted the ECB to beef up its easing measures, were probably more ephemeral than thought. While growth remains fragile, the Eurozone economic surprise index turned the corner in mid-October of last year, suggesting that expectations may have been too pessimistic for the region (chart 2).

This is certainly the case for Germany, which has seen manufacturing activity and economic sentiment rebound significantly since the fourth quarter of last year (chart 3). This has propelled the local stock market upward by close to 25% over the last three months.

How low can bond yields go?

In the meantime, ultra-loose global monetary policy and falling energy prices keep driving long-term bond yields lower and lower (chart 4).

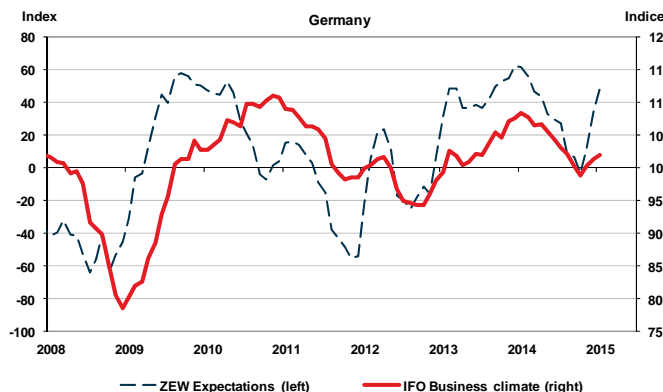
Improvements in Europe



2 Source: Datastream



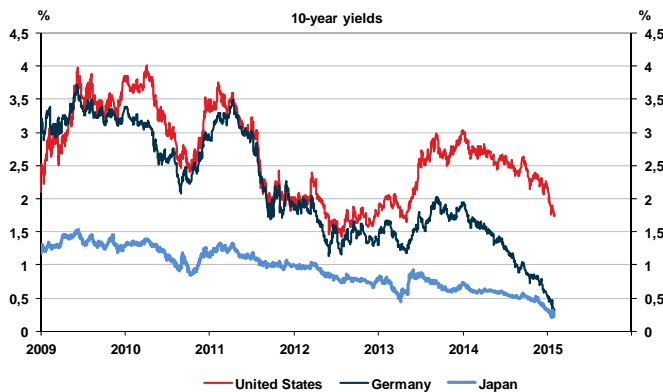
No recession in sight



3 Source: Datastream



Deflation fully priced in Europe



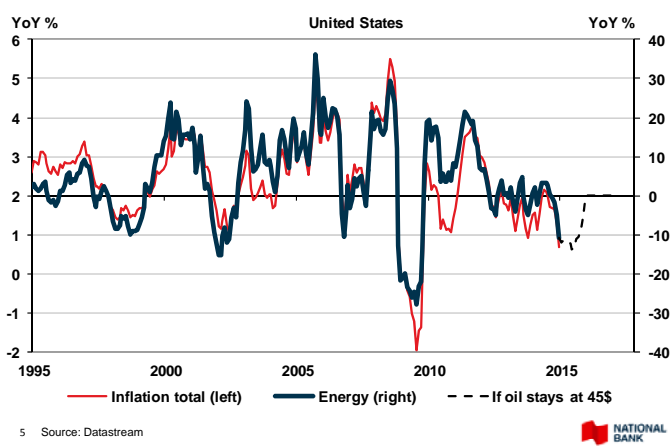
4 Source: Datastream



The main reason is that as long as oil prices keep falling, inflation in the consumer price index, which is highly influenced by fluctuations in its energy component, will trend

down as well. While it may be too soon to call a bottom, it seems to us, however, that at -50% in just six months, the current correction in oil prices, is fairly advanced. What we do know is that if energy prices stabilize at current levels, the downtrend in inflation will likely reverse around July, as year-over-year fluctuations gradually move back towards zero (chart 5).

Reversal in sight if oil prices stabilize



Moreover, while yields in the U.S. will remain impacted by trends elsewhere and the strong foreign demand for the higher yields offered by Treasury securities, this should be offset by Fed signals that key interest rates are closer to be raised.

Asset allocation

So what's a retail investor to do? There seems to be risks at every corner. The possibility of Greece, Russia and Venezuela defaulting on their sovereign debt is high and rising. Bond yields in Europe are already at levels last seen when Japan was oppressed by a deflationary spiral. At 16.7X forward earnings, the U.S. stock market is not a bargain anymore (table 2). This is all true, but there's a flip side to every coin.

First, Venezuela is the most at risk, but the potential impact remains insignificant for global markets. Russia and Greece are wildcards, but the former has plenty of foreign reserves to back up its obligations and the latter has no interest in resurrecting the Drachma. Second, as potential real GDP growth in Europe is in the neighborhood of 1.5%, German 10-year bond, currently yielding 0.4%, are pricing in an assumption that there will be no inflation for the next 20 odd years. But while headline inflation is feeling the transitory effect of lower energy prices, core inflation, which excludes the most volatile components, is still positive. Thus, there is a lot of bad news already priced into bond yields and it is going to take much worse events to bring these yields even lower. Third, the U.S. market is indeed looking expensive. But the lack of alternatives suggests that equities continue to hold the best expected returns for retail investors. Fixed-income securities bought at a premium virtually guarantee that your after-tax real return will be negative, and yields don't even have to go up for that to happen. Meanwhile, equities should continue to benefit from easy monetary policies and accelerating economic growth.

Table 2 Equity valuations (as of Jan. 31 2015)

MSCI index	Share of world cap	Valuations			EPS growth estimates		
		P/B	Div. yield	P/E (12-m fwd)	2014	2015	2016
All country	100%	2.1	2.3%	15.0	4.4%	6.2%	12.2%
Developed markets	89.6%	2.2	2.3%	15.7	4.4%	6.2%	12.2%
United States	48.9%	2.9	1.7%	16.7	5.0%	5.2%	13.1%
Europe ex-UK	24.9%	1.8	3.1%	14.6	4.4%	12.0%	12.0%
United Kingdom	8.1%	1.8	3.8%	14.1	-2.2%	-2.9%	12.7%
Japan	7.8%	1.4	1.7%	14.0	10.4%	11.0%	8.6%
Canada	3.6%	1.9	2.7%	15.6	11.8%	-2.6%	15.2%
Australia	2.7%	2.2	4.8%	14.4	-0.4%	3.7%	10.5%
Emerging markets	10.4%	1.5	2.7%	11.1	0.2%	9.7%	11.8%
China	2.0%	1.6	3.1%	9.6	7.4%	6.0%	12.2%
Brazil	1.1%	1.2	4.6%	10.1	-14.1%	13.7%	19.3%
India	0.7%	3.3	1.2%	17.2	11.1%	16.1%	16.6%
Russia	0.6%	0.4	7.0%	3.8	-18.2%	-7.2%	8.5%
South Korea	1.6%	1.0	1.1%	9.7	-2.8%	19.4%	7.6%
Mexico	0.6%	2.6	1.9%	17.7	-3.1%	16.0%	14.4%

Sources: IBES/Datastream

These days, most stocks offer a higher dividend yield than any developed country's 30-year government bond.

In the short-term, we continue to play it safe by maintaining an overweight position in the U.S. large-cap equity market, which should keep benefiting from a lower relative beta and ongoing improvement in the global economy, and which offers a better exposure to our favorite sector, information technology. Canadian investors will soon have to think about hedging their U.S. dollar positions, but as long as the Bank of Canada maintains its bearish tone and oil prices lack upside momentum, the downtrend in the loonie will prevail (chart 6).

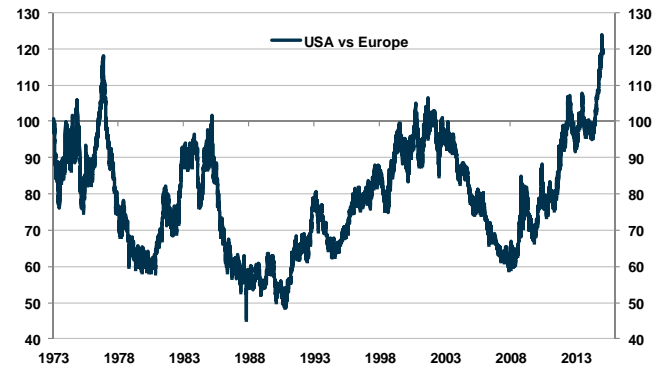
The loonie could bounce in the short term



6 Source: Datastream



Europe is cheap versus U.S. markets



7 Source: Datastream



Over the longer run, however, we think the EAFE region, and particularly Continental Europe, offer the most upside potential. The lower euro, combined with massive liquidity injections from the ECB all but guarantee that risk assets will outperform. As European stocks look historically cheap on both a relative and absolute basis, there could be a timing opportunity to slowly increase the EAFE region exposure to overweight (chart 7). If you think the euro will collapse due to monetary policy divergences between the Fed and the ECB, you might want to hedge your currency risk. However, most EAFE funds are sold in U.S. dollars and, as the loonie is also caught in a landslide, it is difficult to gauge what your best option might be.

Table 2 Global Asset Allocation (Tactical vs Strategic)

3-month horizon						12 to 18-month horizon					
Asset classes	Weight					Asset classes	Weight				
	Min	Under	Equal	Over	Max		Min	Under	Equal	Over	Max
Cash				■		Cash		■			
Bonds		■				Bonds		■			
(Duration)			■			(Duration)		■			
Federal		■				Federal	■				
Investment grade			■			Investment grade		■			
High yield (USD)				■		High yield (USD)				■	
Non-traditional income				■		Non-traditional income				■	
World equities				■		World equities				■	
S&P/TSX			■			S&P/TSX			■		
S&P 500 (USD)				■		S&P 500 (USD)				■	
<i>Growth vs Value</i>			■			<i>Growth vs Value</i>			■		
<i>Large cap. vs Small cap.</i>			■			<i>Large cap. vs Small cap.</i>				■	
<i>Defensives vs Cyclical</i>		■				<i>Defensives vs Cyclical</i>		■			
MSCI EAFE (USD)				■		MSCI EAFE (USD)				■	
MSCI EM (USD)			■			MSCI EM (USD)			■		
Alternative investments			■			Alternative investments			■		
Commodities			■			Commodities			■		
Energy				■		Energy				■	
Base metals				■		Base metals				■	
Gold			■			Gold		■			
Hedge funds (USD)			■			Hedge funds (USD)			■		
REITS		■				REITS		■			

Source: Consulting Investment Committee

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