



INVESTING

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Asset Allocation Strategy

Spring is finally coming!

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Market review

After a shaky month of January, stocks rebounded well last month. The S&P500 led the way with a performance of 5.7% bolstered by strong economic numbers while the S&P/TSX enjoyed strong contributions from the financials (6.7%). In addition to the anticipation of the ECB implementing its QE program, a general decrease in risks stemming from Greece and the Russia-Ukraine conflict helped lift European markets. On the bond side, 10-year notes were weak all month long with yields increasing from 1.68% to 2.00%. The bulls got a small reprieve with Fed Chair Janet Yellen's congressional hearing, but it wasn't enough to offset to overall bearish tone for this asset class last month.

Asset allocation strategy

- In WTI: even though the worst of the price action seems behind us, we are not out of the woods yet as the market anticipates sizeable inventory buildups over the next weeks and some participants are forecasting that Cushing's storage facilities will to be full by mid-April.
- There won't be any movement in the fed fund rates until mid-June at the earliest, but the next step is clearly an increase, not more easing.
- With strong ECB easing measures now in place and with geopolitical uncertainty moderating thanks to the deals in Greece and Russia/Ukraine, risk assets remain well positioned to offer the best expected returns over short and longer-term horizons.
- We do not anticipate a significant pick-up in yields over the short-term, since lower energy prices will continue to put downward pressure on inflation, at least until this summer.
- Canadian dollar: the recent movement in the currency seems a bit overdone we continue to feel that the downtrend still has some legs to it.

Table 1 Market total returns

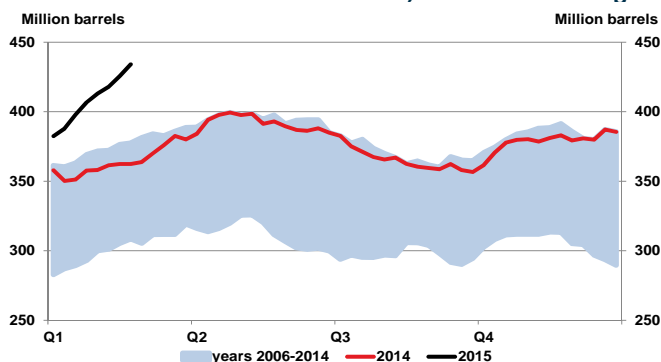
Asset classes	February	YTD	2014
Cash (3-month T-bills)	0.0%	0.2%	0.9%
Bonds (Dex Overall Universe)	-0.1%	4.5%	8.8%
Dex Overall Federal	-0.4%	3.6%	6.9%
Dex Overall Corporate	0.1%	3.7%	7.6%
Dex BBB	0.1%	3.9%	9.0%
BoAML High-Yield (USD)	2.3%	3.0%	2.5%
World equity MSCI (USD)	5.6%	4.0%	4.7%
S&P/TSX	4.0%	4.5%	10.6%
S&P/TSX Small cap	3.2%	3.7%	-2.3%
S&P500 (USD)	5.7%	2.6%	13.7%
Russell 2000 (USD)	5.8%	2.4%	3.5%
MSCI EAFE (USD)	6.0%	6.5%	-4.5%
MSCI EM (USD)	3.1%	3.7%	-1.8%
Commodities (CRB index)	-0.4%	-3.8%	-4.1%
WTI oil (US\$/barrel)	2.5%	-9.2%	-45.4%
Gold (US\$/ounce)	-4.5%	2.5%	-1.8%
Copper (US\$/tonne)	6.9%	-7.0%	-13.7%
Forex (JPM US Dollar index)	0.0%	3.5%	10.0%
USD per EUR	-0.6%	-7.3%	-12.2%
JPY per USD	1.8%	-0.1%	13.7%
CAD per USD	-1.8%	7.6%	9.4%

Source: Datastream

* 2/27/2015

CHART OF THE MONTH

US crude oil: Record inventories, and still increasing!



1 Source: Datastream



The loonie at a crossroad?

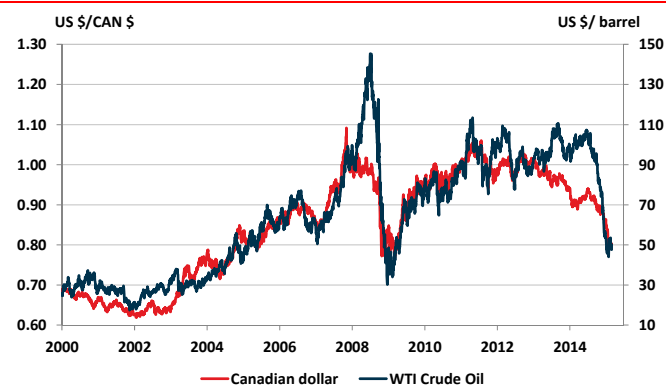
With the rapid depreciation of the Canadian dollar over the past few months we get a lot of questions from investors wondering whether the time is ripe to cash in on our short position. While the recent movement in the currency seems a bit overdone we continue to feel that the downtrend still has some legs to it. To explain this stance, below we review the loonie's main fundamentals.

1- Oil prices: just a dead-cat bounce?

In February, the crude market became comfortable with Western Texas Intermediate (WTI) prices trading in a range between 48 and 55 US dollars per barrel (chart 2). Even though the worst of the price action seems behind us, we are not out of the woods yet as the market anticipates sizeable inventory buildups over the next weeks and some participants are forecasting that Cushing's storage facilities will to be full by mid-April (Cushing, Oklahoma is the WTI delivery point). If this situation materializes, the market will exhibit more price weakness and much higher volatility. The WTI futures contract price is tied to a physical barrel of crude oil and, as such, extreme inventory situations can sometimes result in dramatic price movements.

As this is a supply-driven bear market, there has to be a decrease or a least a stabilization of production before we will see light at the end of the tunnel (Table 2). The major OPEC members now seem unwilling to cooperate and the solution will have to come from elsewhere. This is a paradigm shift from previous oil bear markets where everyone would look to nationalized Middle Eastern oil producers to regulate supply in

The correlation is still going strong



2 Source: Datastream



order to maintain a given price level. With the U.S.A. now accounting for most of the increase in supply, economic imperatives will lead the way in finding the equilibrium. Most privately-owned producers can withstand a certain level of temporary price decrease, since a part of their production is hedged on average two years in advance, and cutting production is not as easy as flipping a switch from on to off.

Surely, the 39% decline in U.S. oil rig counts since October 2014 is an indication that some response is under way but, barring any major geopolitical event disrupting production, one should not anticipate the effects of such a decline to be felt in inventory reports until Q3 (chart of the month).

Table 2 Oil World supply and Demand (in MMB/d)							Projected	
Year	2009	2010	2011	2012	2013	2014	2015	2016
OECD Supply	21.1	21.5	21.6	22.5	23.7	25.5	26.2	26.7
ex-OECD Supply	63.2	65.9	67.0	67.9	67.2	67.4	67.6	67.5
World Supply	84.3	87.4	88.6	90.5	90.9	92.9	93.8	94.2
OECD Demand	46.4	47.0	46.3	45.9	46.1	45.8	46.0	45.9
ex-OECD Demand	38.4	40.4	42.5	43.8	45.2	46.4	47.2	48.3
World Demand	84.8	87.4	88.8	89.7	91.2	92.1	93.1	94.2
World Surplus / Deficit	(0.4)	0.0	(0.2)	0.7	(0.3)	0.8	0.6	0.1
OPEC Supply	33.9	35.3	36.1	37.5	36.5	36.5	36.5	36.2
US Supply	9.1	9.7	10.1	11.1	12.3	13.9	14.8	15.3
China Demand	8.5	9.3	9.5	10.0	10.3	10.7	11.0	11.3

source: EIA via Datastream

2- Interest rate spread: Divergent monetary policies

The Canadian economy, especially western Canada, is now feeling the negative impacts of the weakness in the energy complex. Let’s not forget that the benefits oil production bring to this country show up in all areas of the Canadian economy, from the stock market and job creation to our overall fiscal situation. However, we believe that further downward pressure on the loonie will not only be caused by weakness in the Canadian economy, but also the strength of its southern neighbor, since most U.S. economic indicators are improving, in part due to the unexpected stimulus resulting from lower energy prices. Full-time employment in the U.S. is closing-in on pre-crisis levels and private sector employment is already 2.6% ahead (chart 3).

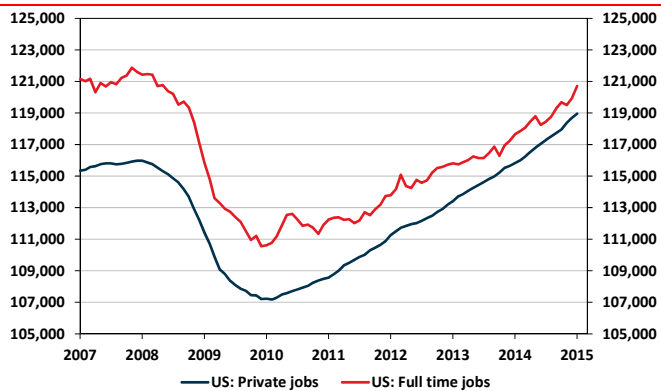
On February 24th, Fed chair Janet Yellen’s testimony to the congress gave some guidance as to how the Fed will proceed with future interest rate increases:

“The FOMC’s assessment that it can be patient in beginning to normalize policy means that the Committee considers it unlikely that economic conditions will warrant an increase in the target range for the federal funds rate for at least the next couple of FOMC meetings. If economic conditions continue to improve, as the Committee anticipates, the Committee will at some point begin considering an increase in the target range for the federal funds rate on a meeting-by-meeting basis. Before then, the Committee will change its forward guidance.”

Basically there won’t be any movement in the fed fund rates until mid-June at the earliest, but the next step is clearly an increase, not more easing.

These two different expectations with regard to economic conditions, prompted a response in the bond market, bringing the two-year spread between Canadian and U.S. bond yields to its lowest level since 2007, which explains most of the recent Canadian dollar depreciation (chart 5).

Employment still improving

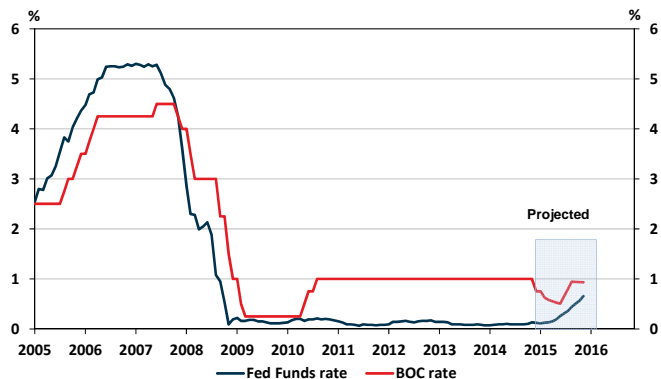


3 Source: Datastream



As such, the Canadian and U.S. central banks are now facing two different sets of problems, with the former now having to decide how accommodative it must be in order to stimulate its economy and the latter slowly returning to a neutral rate policy (chart 4).

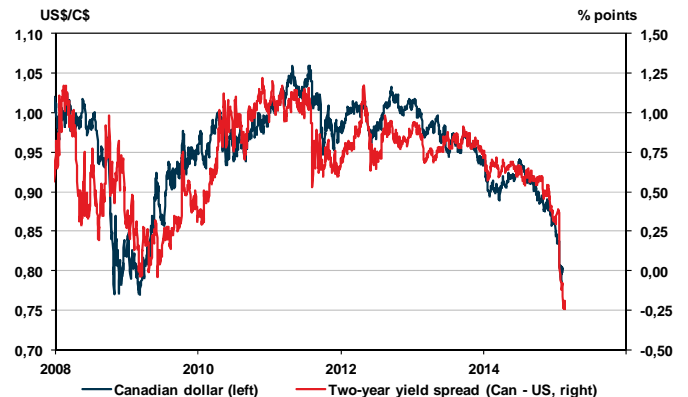
Diverging monetary policies



4 Source: Datastream



Rates felt the effects of diverging central bank policies



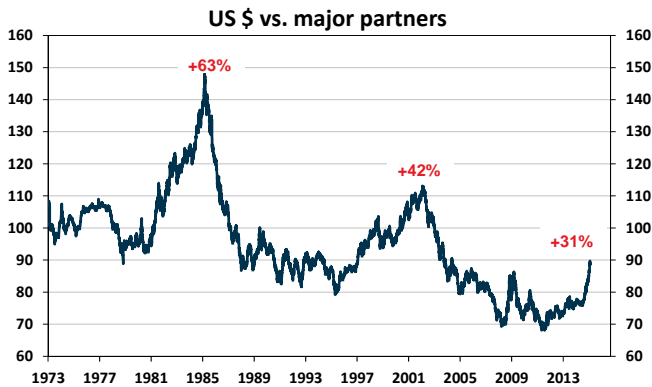
5 Source: Datastream



3- U.S. Dollar: Still strong against major partners

Another thing that bears watching is the strength of the USD. In the past we’ve often seen negative correlation between commodity prices and the U.S. currency, the former being quotes in USD terms. True, the greenback has risen sharply since 2012, but past episodes of rapid USD appreciation suggest that as long as the U.S. economy keeps the lead in terms of relative growth, the rally may only be half way done (chart 6).

Still some space to go up

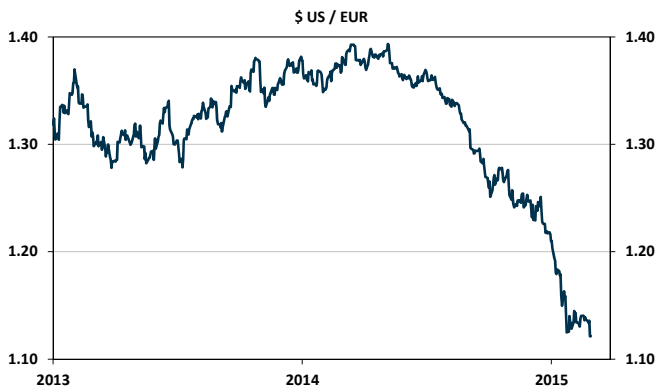


6 Source: Datastream



We have discussed the trend for the loonie at length, but one aspect of the current situation that bears mentioning is that the USD is also just as strong against most other major currencies. In particular, the euro is flirting with cyclical lows and with the European Central Bank (ECB) implementing a massive bond-purchase program in March, the trend for the euro should remain downward (chart 7).

Look out below!



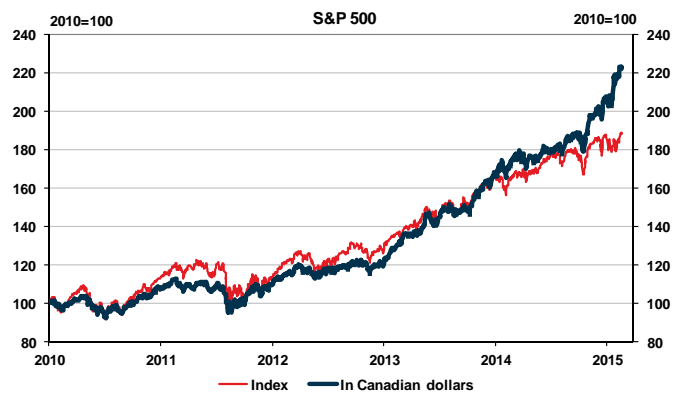
7 Source: Datastream



Asset allocation strategy

With strong ECB easing measures now in place and with geopolitical uncertainty moderating thanks to the deals in Greece and Russia/Ukraine, risk assets remain well positioned to offer the best expected returns over short and longer-term horizons. We continue to favour USD-denominated foreign equities over their Canadian counterparts. True, the U.S. stock market has turned in a stellar performance over the past years, and even more so when expressed in Canadian dollars (chart 8), but we remain convinced that the general trend for resource-heavy markets is still unfavorable.

Great run, but more to come!



8 Source: Datastream



For fixed income, there seems to be a reversal in bond yields worldwide. While the impact of the ECB's bond-purchase program on yields remains to be seen, past episodes of quantitative easing (QE) in the U.S. have always coincided with a rebound in bond yields suggesting that once central proceed with easing measures, the worst of the situation is already behind us. That being said, we do not anticipate a significant pick-up in yields over the short-term, since lower energy prices will continue to put downward pressure on inflation, at least until this summer.

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)				■	
Growth vs Value			■			Growth vs Value			■		
Large cap. vs Small cap.			■			Large cap. vs Small cap.				■	
Defensives vs Cyclical		■				Defensives vs Cyclical		■			
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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