INVESTING

Asset Allocation Strategy

April showers bring May flowers

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Market review

Volatility and high correlation was the name of the game in March as some equity markets saw variations of 4% during the course of the month, with trends changing on a weekly basis. The month was split in two different periods, with the Federal Open Market Committee's (FOMC) accommodating mid-month statement reversing the course set in the first half, and alleviating the fears the Federal Reserve would be tightening rates because of a strong US employment market.

The S&P 500 lost 1.6% while the S&P/TSX finished down 1.9%, with the energy and financial sectors being the main contributors to the underperformance. On the bond side, U.S. 10-year notes yields were basically flat before the Fed meeting, then weakened a bit afterwards to finish the month at 1.93% (down 0.07%).

Asset allocation strategy

- The Fed already ruled out a rate hike in April, and with the ranges for GDP projections and core inflation for 2015 now 0.3% lower than forecast in January, September seems to be a more likely timing for a hike than June.
- The US dollar's overall resilience in light of a more dovish Fed and weaker than expected economic numbers confirms our decision to favour USD-denominated foreign equities over the Canadian market.
- The recent weakness in the U.S. dollar and geopolitical risks are keeping a floor price under crude which is now benefiting from this temporary situation. However, if the U.S dollar was to strengthen again, we would expect West Texas Intermediate (WTI) prices to fall to new lows.
- We feel most of the headwinds the U.S. economy has faced recently will subside as the year progresses, and the U.S. dollar will perform accordingly
- The improving US economy, Quantitative Easing in Europe and low energy prices should help risk assets deliver superior returns over the medium to long term.

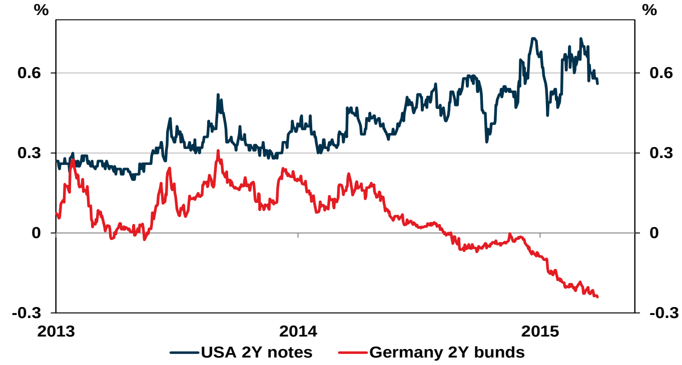
Table 1 **Market total returns**

Asset classes	March	YTD	2014
Cash (3-month T-bills)	0.1%	0.2%	0.9%
Bonds (Dex Overall Universe)	**-0.3%**	**4.2%**	**8.8%**
Dex Overall Federal	-0.3%	3.3%	6.9%
Dex Overall Corporate	-0.1%	3.6%	7.6%
Dex BBB	-0.1%	3.8%	9.0%
BoAML High-Yield (USD)	-0.5%	2.5%	2.5%
World equity MSCI (USD)	**-1.5%**	**2.4%**	**4.7%**
S&P/TSX	-1.9%	2.6%	10.6%
S&P/TSX Small cap	-3.8%	-0.3%	-2.3%
S&P500 (USD)	-1.6%	1.0%	13.7%
Russell 2000 (USD)	1.6%	4.0%	3.5%
MSCI EAFE (USD)	-1.4%	5.0%	-4.5%
MSCI EM (USD)	-1.4%	2.3%	-1.8%
Commodities (CRB index)	**-1.4%**	**-5.2%**	**-4.1%**
WTI oil (US$/barrel)	-3.5%	-11.6%	-45.4%
Gold (US$/ounce)	-2.4%	0.1%	-1.8%
Copper (US$/tonne)	2.4%	-4.8%	-13.7%
Forex (JPM US Dollar index)	**1.6%**	**5.1%**	**10.0%**
USD per EUR	-4.2%	-11.2%	-12.2%
JPY per USD	0.5%	0.4%	13.7%
CAD per USD	1.4%	9.2%	9.4%

Source: Datastream * 3/31/2015

CHART OF THE MONTH

Different Central Bank policies… different results!



1 Source: Datastream

And the word of the month is: Patience

Fed meetings have the potential to sway the markets, as any change in tone can very quickly confirm or reverse the assumptions made by participants. This month was one of those cases. As expected word “patient” was removed from the FOMC statement this month but, as pointed out by Chair Yellen during the press conference that followed, this doesn’t mean the Fed will be impatient with its normalization process. The Fed already ruled out a hike in April and with the ranges for GDP projections and core inflation for 2015 now 0.3% lower than forecast in January, September seems to be a more likely timing for a hike than June.

The meeting also implied a change not only with regard to “when” but also on “how” the normalization process would eventually unfold. At the March meeting, the Fed’s “dot plot”, which shows where participants see the federal funds rate at the end of specific years going forward, revealed the expectation of a sizeable deceleration in the pace of eventual rate hikes (Table 2). Currently, only 24% of the 17 members expect rates to be higher than 1% at the end of 2015, compared to 53% at the December meeting.

Table 2: DOT PLOT

PERCENTAGE OF FED PARTICIPANT'S VIEW ON APPROPRIATE TARGET RATE FOR SPECIFIED PERIOD

TARGET RATE	2015 average rate		2016 average rate	
	December 2014 meeting	March 2015 meeting	December 2014 meeting	March 2015 meeting
0% to 1%	41%	76%	6%	6%
1% to 2%	53%	24%	18%	53%
2% to 3%	0%	0%	41%	18%
more than 3%	0%	0%	35%	18%

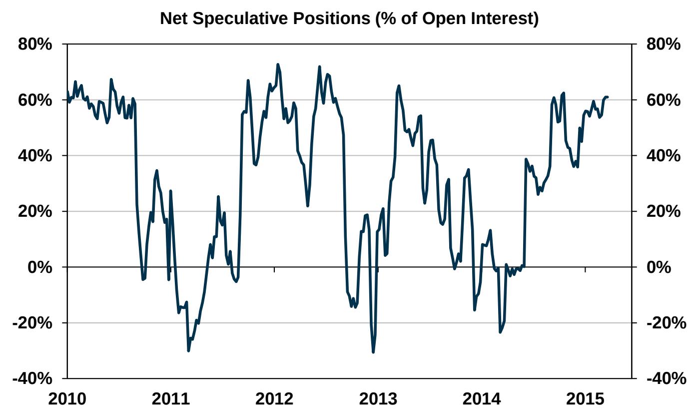
Source: U.S. Federal Reseve website

This softening of pace should not be interpreted as a lack of conviction from the Fed with regard to the necessity of rate increases, but rather that it will be sensitive to the ongoing situation in acting. True, employment is still improving at a fast pace, but inflation is low, largely reflecting the sharp fall in oil prices, which gives the Fed some time to maneuver at least until the pass-through from the buoyant labor market will be visible in wages. Any clear uptick in the latter would be interpreted as a green light to start hiking rates.

USD should strengthen after reassessment of Fed policy

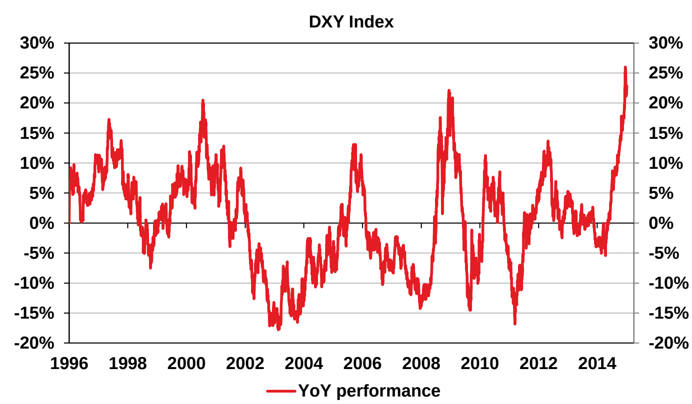
With the greenback running red hot, a pullback was to be expected following the Fed meeting. Speculative positions on the U.S. dollar were at an extreme point and with the year-over-year change at a 6-year high, the recent pace of appreciation was clearly unsustainable in the short term (charts 2 and 3). As such, after falling below 1.05 USD for the first time since 2003, the euro finished the month near the 1.07 mark.

A little too long



2 Source: Datastream

A little overdone



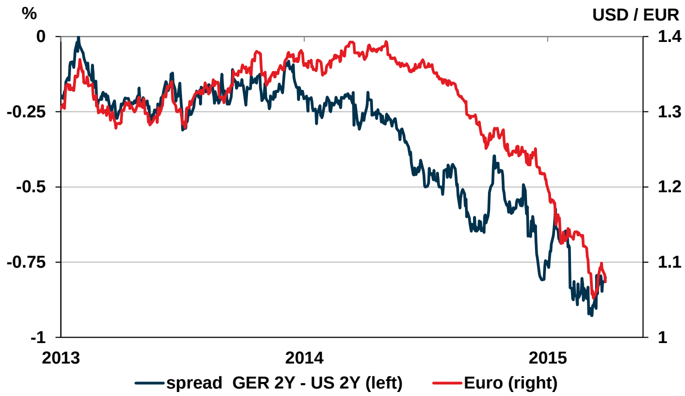
3 Source: Datastream

However, this should not make us reconsider our conviction about the USD strength and one should see the current situation as a temporary pullback in a longer-term uptrend. While the Fed is still expected to be the first to bring its key rates on a path of normalization, the ECB has just embarked on a massive bond purchase program. This situation is pushing the rate differential between Europe and the US higher, and should limit any further downside in the short term (chart 4, next page and chart of the month).

U.S. economy: Is the best yet to come… again?

Moreover, it seems the US economy is once again stuck in “seasonal” blur. Over the last few years, there has been a trend where economic surprises tended to weaken in the first half of the year and this winter, much like 2014, seems to have been heavily impacted by extreme cold weather. This, combined with very high hopes for the U.S. economy following the

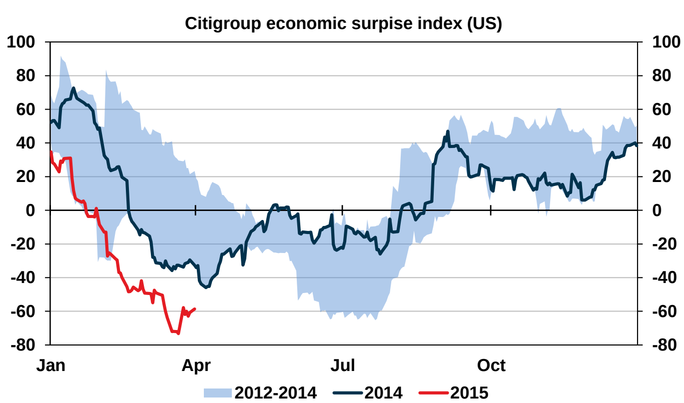
Rates spread will help USD maintain its strength



4 Source: Datastream

blistering pace set by real GDP growth in Q2 and Q3 of 2014, was perhaps the perfect recipe for a re-assessment of market expectations. However, since 2012, the surprise index has never been negative in the fourth quarter, (chart 5) and any turnaround in 2015 could set the stage for a market rebound.

History is bound to repeat itself



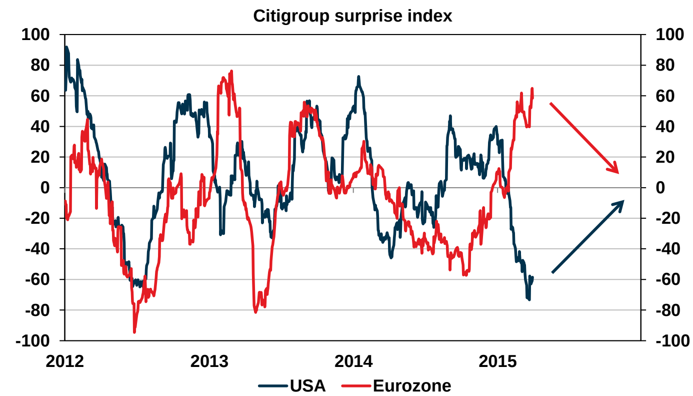
5 Source: Datastream

The DAX benefited from QE, but is it time for a breather?

As the U.S. seemed to slow down, the situation was completely different in the Euro Zone with the economic surprise index reaching its highest level since 2013 (chart 6).

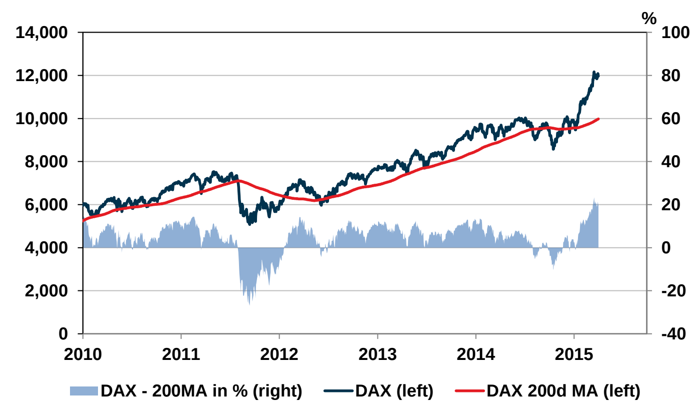
This was mostly visible in the German stock market which, benefiting from Mr. Draghi's QE and strong GDP Q4 numbers (2.8% annualized), has rebounded by more than 40% since October of last year. While we believe European stocks are still appealing from a long-term perspective, recent DAX performance suggests some weakness or consolidation may be ahead (chart 7).

The spread is favorable… for the US!



6 Source: Datastream

Addicted to QE



7 Source: Datastream

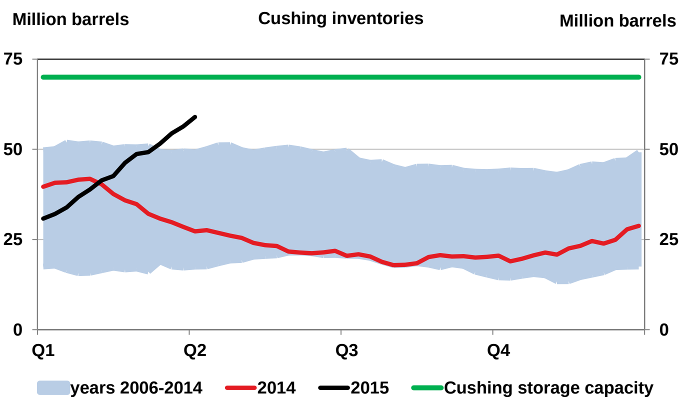
The clock is ticking for crude oil

The geopolitical risk premium became relevant again as Saudi Arabia, with the United States' blessing, is leading a coalition to support the Yemeni (Sunni) government against Houti (Shia) rebels, which are rumoured to be tied to Iran.

Yemen by itself is only a marginal crude oil producer, but it's the implied risks stemming from this action that are pushing crude prices higher, since this may raise more barriers to a US-Iran deal. A worse outcome would be the closure of the Bab el-Mandeb Strait through which 3.5 million barrels of oil transit every day, or a direct conflict between Iran and Saudi Arabia over the long term. The probabilities of this occurring are very low for now. Geopolitical premiums in the price of crude oil are all about what "could" happen, and these premiums can disappear as fast as they appeared, especially in a market with huge surpluses where disruptions have less impact than was the case in the past. For example, if there's a resolution or a U.S.-Iran deal, we would expect the premium to subside fairly quickly.

Inventory-wise, not much has changed in the crude oil markets. The build-ups continue to accumulate at the pace of 8 million barrels per week on average in the continental US and 2 million barrels per week in Cushing, Oklahoma (the WTI delivery point). The talk about inventories reaching capacity constraints around mid-May in Cushing are intensifying (chart 8).

Getting there!



8 Source: Datastream

The recent weakness in the U.S. dollar and geopolitical risk are keeping a floor under oil prices as crude is now benefiting from a temporary situation. However, if the U.S. dollar was to strengthen again, we would expect WTI prices to fall to new lows. Assessing what would happen to crude prices when there are inventory constraints is not an easy task as a lot of new arbitrage opportunities open up. Nonetheless, we feel the downside risks are more prevalent and their impact would be much more severe on the price action than any constructive news.

Asset allocation strategy

The U.S. dollar's overall resilience in light of a more accommodating Fed and weaker-than-expected economic numbers confirms our decision to favour USD-denominated foreign equities over the Canadian market. The energy complex is still vulnerable to inventory overhang in the short term, and it will take more production cutbacks to bring the market back into equilibrium.

We believe that most of the headwinds the U.S. economy has faced recently will subside as the year progresses. The labour market is a key driver of economic growth and it is still posting robust numbers. Once the winter effect fades, the remaining economic indicators should follow. Although the Fed is expected to raise its key rates sometime in the second half of 2015, a pickup in U.S. activity, liquidity injections by the ECB and low energy prices should help risk assets, particularly equities, deliver superior returns over the medium to long term compared to other asset classes.

With regard to fixed income, the U.S.-E.U. rate differential makes the U.S. market an attractive destination for capital inflows, and we think that this will limit any significant pick-up in yields for the short-term. We also favor riskier assets such as investment-grade corporate bonds or high-yield bonds over treasuries since we don't foresee any major negative credit-related events in the short/medium term, and given that the higher coupon rates offered by those assets will offer some protection against the eventual tightening of monetary policy.

Table 2 Global Asset Allocation (Tactical vs Strategic)

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

Source: Consultating Investment Committee