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Asset Allocation Strategy

Don’t ~~fight~~ fear the Fed

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Market review

Performance-wise, the month of May proved relatively uneventful. The S&P/TSX lost 1.2% of its value, weighed down by the financial (-1.6%) and energy (-6.0%) sectors. The S&P 500 (+1.3%) was the mirror image of its Canadian counterpart, with only two sectors posting negative returns. Volatility in energy markets was high, with many days showing price variations in excess of 3%. In spite of daily movements, oil traded in a fairly tight range of $57 to $61 per barrel.

On the bond side, U.S. 10-year treasury yields increased by a meagre 0.05% during the month, as markets wait to see whether the economy will improve compared to Q1, which could finally push the U.S. Federal Reserve (Fed) to act.

Asset allocation strategy

- While some indicators suggest that equities may be currently overvalued and carry a high risk of a correction should the Fed raises rates, we think there may still be some space for further appreciation. S&P 500 forward earnings are now turning a corner and the number of positive revisions is trending upward, which bodes well for future returns.
- Though the rebound in 2015 may not be as strong as that witnessed in 2014, we expect to see solid numbers for the rest of the year, which should contribute to the pressures prompting the Fed to act.
- With the year-over-year inflation now standing at 0.8%, the Bank of Canada can certainly afford the luxury of being dovish and trying to lower expectations of rate increases if the loonie strengthens.
- In spite of the performance of the energy markets, we think that the rebound may prove temporary as the USD strengthens, and we remain confident that the general trend is still unfavorable for resource-heavy markets and their currencies.

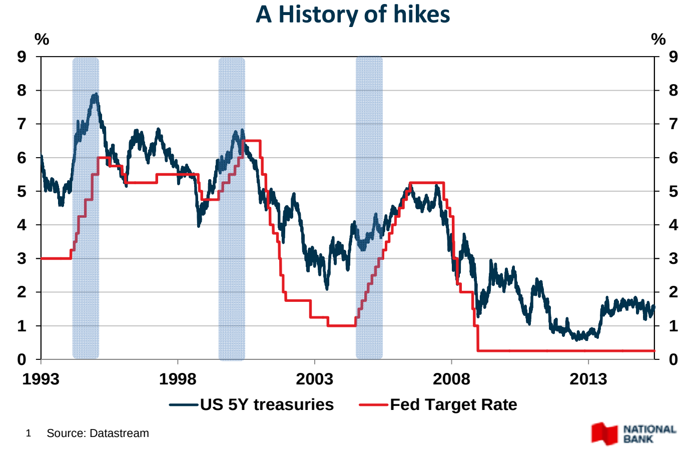
Table 1 Market total returns

Asset classes	May	YTD	2014
Cash (3-month T-bills)	0.1%	0.3%	0.9%
Bonds (Dex Overall Universe)	**0.2%**	**2.9%**	**8.8%**
Dex Overall Federal	0.2%	2.2%	6.9%
Dex Overall Corporate	0.2%	2.8%	7.6%
Dex BBB	0.3%	3.0%	9.0%
BoAML High-Yield (USD)	-0.3%	3.8%	2.5%
World equity MSCI (USD)	**-0.1%**	**5.4%**	**4.7%**
S&P/TSX	-1.2%	3.8%	10.6%
S&P/TSX Small cap	0.3%	4.8%	-2.3%
S&P500 (USD)	1.3%	3.2%	13.7%
Russell 2000 (USD)	2.2%	3.5%	3.5%
MSCI EAFE (USD)	-0.4%	8.9%	-4.5%
MSCI EM (USD)	-4.0%	5.8%	-1.8%
Commodities (CRB index)	**0.9%**	**-3.0%**	**-4.1%**
WTI oil (US$/barrel)	2.2%	11.7%	-45.4%
Gold (US$/ounce)	0.8%	0.3%	-1.8%
Copper (US$/tonne)	-5.6%	-5.7%	-13.7%
Forex (JPM US Dollar index)	**1.7%**	**4.7%**	**10.0%**
USD per EUR	-2.2%	-9.4%	-12.2%
JPY per USD	4.0%	3.7%	13.7%
CAD per USD	3.1%	7.1%	9.4%

Source: Datastream * 5/29/2015

CHART OF THE MONTH

A History of hikes



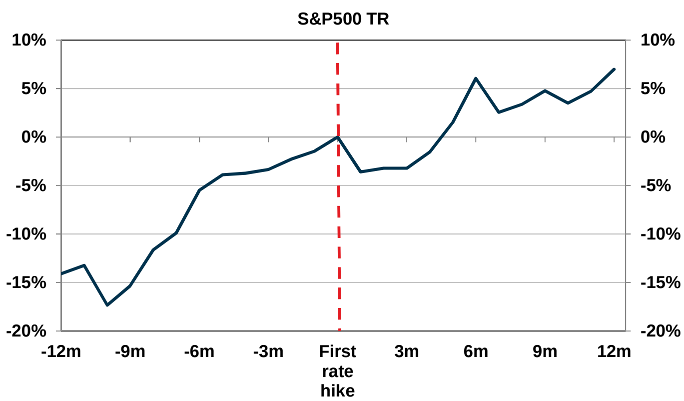
Trying to predict the effects of normalization

As the US economy improves, pressure on the Fed to normalize interest rates will only intensify. Even if the timing of the first hike remains unclear, one can never be too prepared and a study of different market reactions to monetary tightening can help in understanding where the risks lie. For our analysis, we studied the most recent target rate increases: February 1994, June 1999 and June 2004 (chart of the month).

Impact on equities:

If you think an interest-rate hike or the end of easy liquidity would inevitably have a negative impact on equity markets, past episodes of monetary tightening suggest that you are in line for a disappointment (Chart 2).

Better than expected?

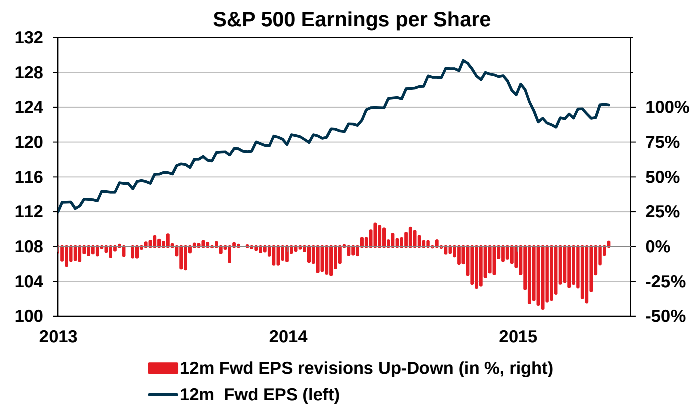


2 Source: Datastream

First, history shows that in the twelve months preceding a rate increase, stocks tend to post an average return of 14%, with markets benefitting from the strong economic environment that usually prompts central bankers to adopt more restrictive policies. True, the two to three months following a rate hike tend to be more challenging, with stock markets falling by approximately 3% to 4% on average. This can be explained to some degree by the uncertainty about potential future increases, and how they could affect growth and the prospects for earnings. However, once the dust settles and monetary tightening is well in place and understood, fear tends to subside and attention eventually reverts back to the overall macro-economic picture, helping equities rebound and post respectable 7% returns on average for the twelve month period following the initial target rate hike.

While some indicators are showing signs that equities may be currently overvalued and at a high risk of a correction should the Fed act, we think there may still be some space for further appreciation. S&P 500 forward earnings are now turning a corner and the number of positive revisions is trending upward, which bodes well for future returns (chart 3). As such, barring an exogenous shock to the system, there is no indication that markets shouldn't react as they did during previous periods of target-rate increases.

Turning a corner



3 Source: IBES, Datastream

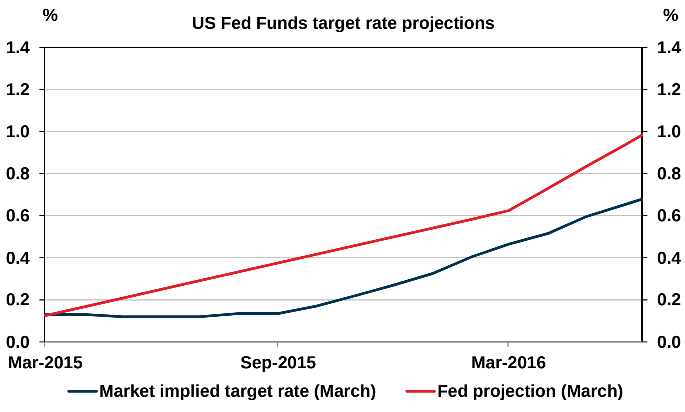
Impact on bond yields:

Expectations can play a big part on how bond yields react to a rate increase. While yields on longer-term maturities tend to front run the first rate hike, there is always an element of surprise when the increase actually happens. The biggest impact was in 1994 when yields on 5-year treasury securities shot up from 5.2% to 7.4% over the twelve-month period following the initial hike. The reason for such a big move was that, contrary to 1999 and 2004, the February 1994 rate increase was unexpected – even if, in retrospect, inflation and unemployment seemed to justify the move. Markets were caught off-guard by the aggressive pace of tightening set by the Fed at subsequent meetings.

Predicting future bond performance when the market is in flux is a difficult task. However, tools are available to help assess the risks and test some scenarios. One of them is bond duration – a measure used to determine the sensitivity of a bond to changes in interest rates. Using current bond index durations, we calculate that a 1% increase in rates would probably translate into a 6% - 6.5% loss for U.S. bond indices and a 7% - 7.5% drop in value for the Canadian benchmark.

On the surface, one can draw a lot of parallels between the 2008-2015 and 1989-1994 periods. Both witnessed credit crises (the Savings and Loan debacle in 1989) and jobless recoveries. However, one very important difference is that today, the Fed is much more transparent in communicating its assessment of the economic situation and the course of action it intends to take in the near future. Though market expectations are currently at odds with the Fed's assumptions about the timing of any action (chart 4), we think that the pace of future increases is much more important, and both the Fed and financial markets seem in agreement with regard to this. For that matter, we doubt yields will move as violently as they did in 1994 once the Fed decides to act.

Who will be right?



4 Source: Datastream

As such, 1999 and 2004 probably offer better indications of where we're headed this time. For these two periods, 5-year yields rose significantly in advance of the first hike in the Fed funds target rate, but reacted much less after the Fed did move.

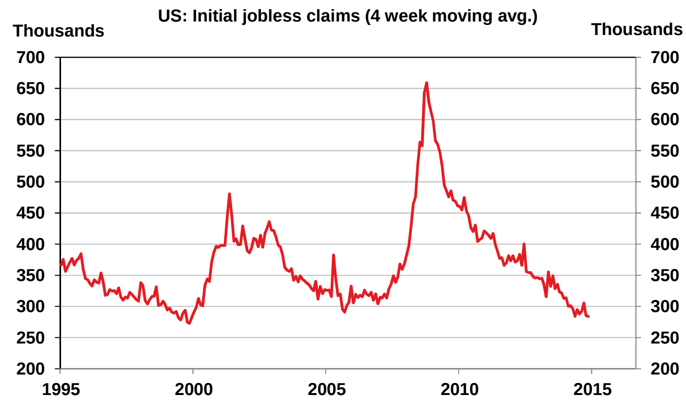
So, when will normalization happen?

While every period has its own particularities, the beginning of a tightening cycle always coincides with a period where maximizing employment (the Fed's first mandate) becomes at odds with price stability (the Fed's second mandate). As the Fed continues on a data-dependent but forward looking path, we think a review of economic factors can shed some light on the probable timing of the first rate hike.

Labor market (positive to rate increase):
Employment seems to have been fairly resilient in the face of the Q1 soft patch caused by a harsh winter and Western port strikes that affected exports. Initial jobless claims are at level not seen since 2000 (chart 5), and most employment indicators are robust and fairly consistent. As a result, wage inflation has started to creep up, while the unemployment rate continues its downward drift (chart 6). A further increase in salaries and employment costs would be a strong signal for more restrictive action by the Federal Open Market Committee (FOMC).

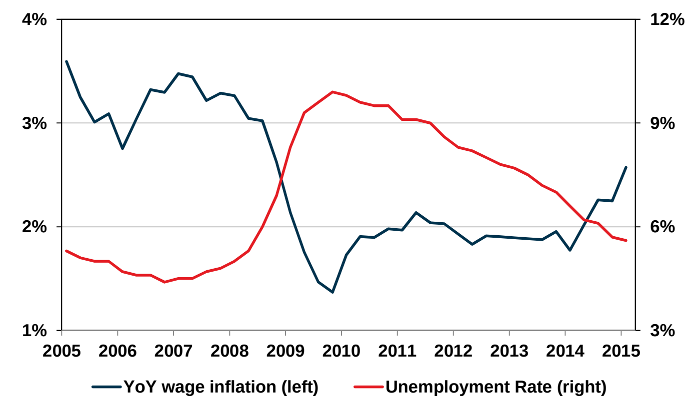
Inflation (negative to rate increase):
Wage inflation is still tame and core inflation is reasonable at 1.8%, since the strength of the US dollar has put a cap on

Back to the Clinton era!



5 Source: Datastream

Creeping up

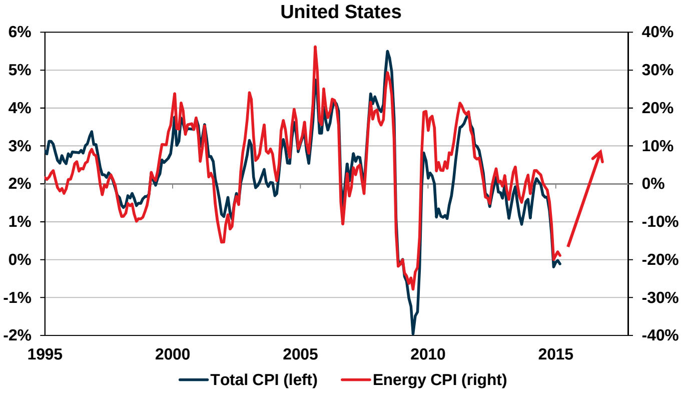


6 Source: Datastream

import prices and offset some of the potential price increases that would be expected from an improving economy. However, let's not forget that the impact of lower energy prices on total inflation is temporary. As the year advances, a stabilization or rise in oil prices will translate into much higher inflation toward the beginning of 2016 (chart 7, next page).

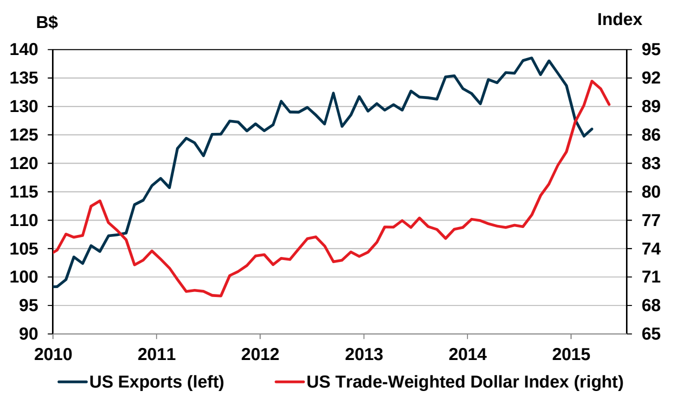
FOMC minutes (positive to rate increase):
The Fed members debated whether Q1 numbers were reflecting a real loss of momentum or just a subset of transitory factors. Though they eventually concluded it was probably the latter, they are still worried about the impact of the strong USD on exports (chart 8, next page). FOMC members also implied that June was probably off the table for a target rate increase since they are waiting for confirmation that the economy really is picking up steam. They are also worried about the de-stabilizing effect rate normalization would have on the long term yields.

Rebound in the making



7 Source: Datastream

USD putting the breaks on exports



8 Source: Datastream

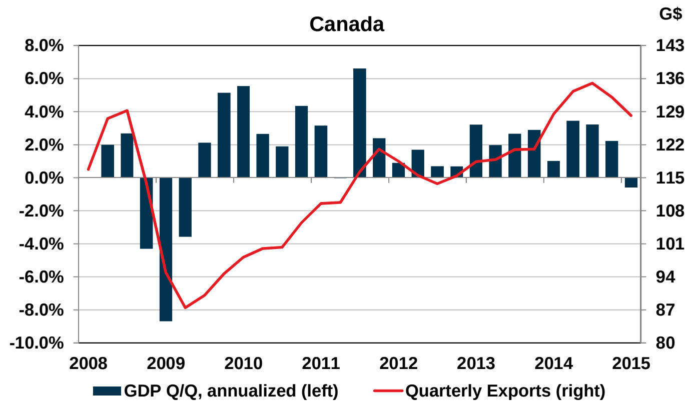
However, we do think that history has a tendency to repeat itself, with economic surprise indices and leading indicators trending up after the winter blues. In April, home prices were 8.3% higher than a year ago and the ISM manufacturing index jumped to 52.8 in May. Therefore, after worse-than-expected first quarter real GDP growth, things are looking good for a pick-up in activity. Though the rebound in 2015 may not be as strong as the one we witnessed in 2014, we expect to see solid numbers for the rest of the year, which should contribute to the pressures prompting the Fed to act.

Bottom line:
We still believe September is in the cards for the first normalization action, since employment continues to improve and we will finally have the weak Q1 behind us. However any negative surprises would probably push that date further out. Even if inflation seems relatively tame, we must not forget that any monetary policy set by the Fed takes a long time to produce results, so even if the recent economic numbers don't necessarily require immediate restrictive action, by the time the increase appears justified, it may well be too late. We also think the "no sudden movements" approach the Fed is using by announcing its intentions well in advance is a wise one since it will probably reduce the volatility that a new direction in monetary policy would be expected to produce.

What about Canada?

The drop in energy prices compounded with a harsh winter weighed heavily on first quarter real GDP numbers which came out at -0.6% annualized, the worst result since the 2008/2009 recession (chart 9). The consumption stimulus effect expected from lower gasoline prices did not materialize as the savings rate jumped by 5% during that period.

Looking for light at the end of the tunnel



9 Source: Datastream

Bank of Canada (BoC) Governor Poloz stated that he expects the situation to improve in the second half of the year as the energy shock eventually subsides and exports to the U.S. pick up. But the Canadian dollar remains an issue:

"The Canadian dollar has strengthened in recent weeks in the context of higher oil prices and a softer U.S. dollar. If these developments are sustained, their net effect will need to be assessed as more data become available in the months ahead."

With year-over-year inflation now standing at 0.8%, the Central Bank can certainly afford the luxury of being dovish and trying to lower expectations of rate increases if the loonie strengthens. This stance added to an eventually more restrictive Fed should weaken or at least put a ceiling on the Canadian dollar.

Asset Allocation Strategy

We managed to navigate through the treacherous "sell in May" period, and markets have been range-bound for the last couple of months as participants follow the Greek situation and different conflicts in the Middle East. But the European Central

Bank monetary easing continues uninterrupted and the U.S. economy emerges from a soft patch. Therefore, we still think risk assets remain positioned to offer the best expected returns over both short and longer-term horizons.

In spite of the performance of the energy markets, we think that the rebound may prove temporary as the USD strengthens and we remain confident that the general trend is still unfavorable for resource-heavy markets and their currencies. As a result, we continue to favor USD-denominated foreign equities over their Canadian counterparts.

We maintain our underweight position in fixed income since yields continue to look unattractive. We expect the effect of low energy costs to wane and the annual change in the consumer price index to increase gradually as the year progresses. Another factor the Fed will keep an eye on is wage inflation, which is under increasing upward pressure as the U.S. employment situation continues to improve. The Federal Reserve is still leaning towards a hike by the end of the year, although the rate of increase may prove less severe than was expected in the previous quarters. In light of this, we favor assets that offer some protection against monetary policy tightening, such as high yield or corporate bonds which have a shorter duration and higher coupon rates.

Table 2 **Global Asset Allocation (Tactical vs Strategic)**

Asset classes	3-month horizon: Min	Under	Equal	Over	Max	12 to 18-month horizon: 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: Consulting Investment Committee