

Asset Allocation Strategy

Greece: Noise or a real risk?

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Market review

Markets seasawed all month long as all eyes were on Greece, with everyone waiting for some form of resolution. On June 29th, the Greek Prime Minister announced a surprise referendum to be held on July 5th (please refer to box 1). As expected, the news was badly received, and this was the main reason equity markets performances performed poorly last month.

However, bond and currency markets remained fairly tame in the face of this uncertainty. US ten-year treasury yields fell by only 0.13% following the announcement of the referendum, and were up 0.10% for the month, with the Euro rebounding after the initial shock to close the month up 0.015 USD/EUR.

Asset allocation strategy

- We think that over the medium to long-term horizon, the Eurozone economic rebound should resume, and that stocks will perform accordingly.
- We remain underweight government bonds for the short-term, but see 10-year yields rising to 3% as a buying opportunity.
- Since traditional bonds offer no protection against rising inflation, we think it's time to consider inflation-linked bonds (ILBs).
- Though corporate and high yield bonds are exposed to potential credit events, we think the additional yields and duration protection are worth the risk at the moment.
- We continue to favour U.S.-dollar denominated equities. The S&P 500 should resume its uptrend in the second half of the year as the economy picks up steam.

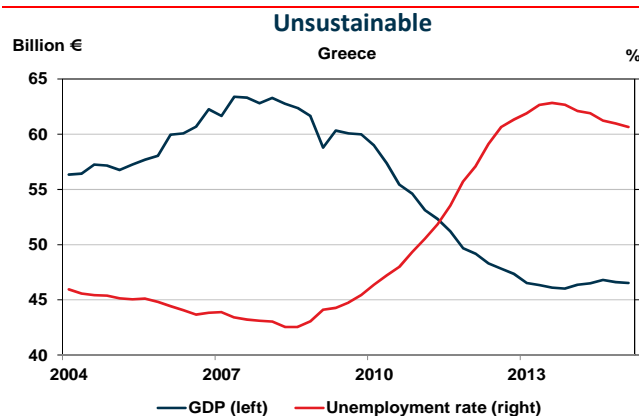
Table 1 Market total returns

Asset classes	June	YTD	12-mths
Cash (3-month T-bills)	0.1%	0.4%	0.9%
Bonds (Dex Overall Universe)	-0.6%	2.4%	6.3%
FTSE/TMX Federal	-0.2%	2.1%	5.3%
FTSE/TMX Corporate	-0.5%	2.2%	5.0%
FTSE/TMX BBB	-0.6%	2.4%	5.2%
BoAML High-Yield (USD)	-1.5%	2.5%	-0.5%
World equity MSCI (USD)	-2.3%	3.0%	1.2%
S&P/TSX	-2.8%	0.9%	-1.2%
S&P/TSX Small cap	-3.5%	1.1%	-16.4%
S&P500 (USD)	-1.9%	1.2%	7.4%
Russell 2000 (USD)	0.6%	4.1%	5.1%
MSCI EAFE (USD)	-2.8%	5.9%	-3.8%
MSCI EM (USD)	-2.5%	3.1%	-4.8%
Commodities (CRB index)	0.4%	-2.6%	-14.1%
WTI oil (US\$/barrel)	-1.3%	10.3%	-43.7%
Gold (US\$/ounce)	-1.7%	-1.4%	-11.2%
Copper (US\$/tonne)	-4.2%	-9.6%	-18.3%
Forex (JPM US Dollar index)	-0.4%	4.3%	15.5%
USD per EUR	1.6%	-7.9%	-18.6%
JPY per USD	-1.3%	2.3%	20.9%
CAD per USD	0.4%	7.5%	17.1%

Source: Datastream

* 6/30/2015

CHART OF THE MONTH



Box 1**Greece: Noise or real risks for financial markets?**

As all eyes are on Greece, we think a description of what is happening - or what could happen - will be of help in assessing the situation and risks.

Important dates (past and future):

- **June 27:** Greek PM Alexis Tsipras announced that a referendum would be held on the bailout agreement on July 5, 2015.
- **June 28:** The European Central Bank (ECB) halted Emergency Liquidity Assistance (ELA) to Greek banks, thus forcing the government to impose capital controls, effectively closing the banks until July 7 and limiting cash withdrawals to 60 Euros per day.
- **June 30:** Greece missed the deadline for a 1.6bn EUR payment to the International Monetary Fund (IMF) and the ECB.
- **July 5:** The “no” wins with about 60% of the vote.
- **July 6:** Yanis Varoufakis, the Greek finance minister, resigns.
- **July 20:** Payment due date for 3.5bn EUR that Greece owes the ECB.

About the meaning of the July 5 results:

Although Tsipras said that a “No” result would send a clear signal to the creditors and ultimately help him negotiate better terms for a settlement to the crisis, we doubt that the ECB will be willing to offer better bailout terms. PM Tsipras indicated that the referendum is on whether or not to accept the ECB proposals and nothing else, but the results certainly increase the chances of Greece leaving the European Monetary Union if negotiations fail.

The situation remains uncertain. Polls suggest that most Greeks want to stay in the EU, but do not agree with the terms or sacrifices imposed by the creditors. It is hard to predict how the aftermath of the referendum will unfold, but Greeks are well aware of how dire their situation would be should they decide to leave the Eurozone. The best outcome would be for all parties involved in the negotiations to find common ground that would be acceptable politically in their respective countries. The German population is experiencing “Grexit” fatigue and on the other side PM Tsipras has to respect in some form the promises made during the last election campaign and referendum. An agreement will require some big compromises on both sides of the negotiation table and the resignation of Mr. Varoufakis, who was considered a very contentious figure by the creditors, will certainly help in that matter.

What would happen if the “Grexit” finally occurs?

The easy answer is increased market volatility in the short term and pain for the Greeks in the long term. Greece represents roughly 3.3% of the Eurozone population and 1.8% of its GDP, so it is not considered a major player for the EU. A crisis that has been analyzed and discussed years in advance gives the luxury of having participants well prepared for such an occurrence. There is a possibility that risk premiums could increase for Spain, Italy and Portugal, since the “Grexit” would set a precedent for other members leaving the eurozone. However, the Eurozone is certainly ready to limit credit and liquidity risks with its QE, Outright Monetary Transactions and banking union.

Bottom line:

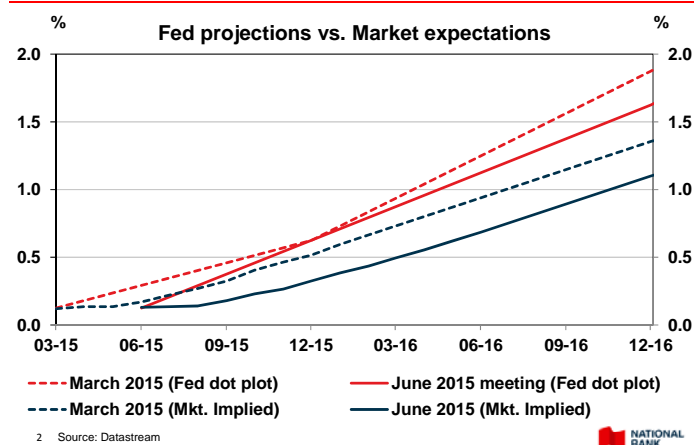
Eurozone stock markets are at risk of a short-term drop and will be much more volatile as we wait for the dust to settle. Our base case scenario is still that there will eventually be an agreement since most Greeks want to remain in the EU and the EU wants to keep Greece as a member. Moreover, the European economy is much stronger today than it was in 2011 when Greek difficulties first emerged, and the mechanisms put in place by the ECB to limit the chances of a credit or liquidity crisis should help reduce the risk of contagion. We think that over the medium to long-term horizon, the Eurozone economic rebound should resume, and that stocks will perform accordingly.

Government bonds: Waiting on the Fed

The Federal Open Market Committee (F.O.M.C.) June statement didn't contain any surprises. After an unexpected slow start to the year, members remain on the lookout for continued improvement in the US economy and inflation risks before pulling the trigger.

As usual, the meeting's projection materials and the following press conference by chair Yellen were more interesting than the statement itself. The "dot plot" – the survey which shows what each member thinks should be the appropriate interest rate path – showed a less aggressive pace of hikes than the previous one in March (chart 2). Moreover, the central tendency for the 2015 unemployment rate projection was increased from 5.0-5.2% to 5.2-5.3%, while the forecast for real GDP growth was downgraded significantly from 2.3-2.7% to 1.8-2.0%.

Softer path of increase than three months ago



However, this is more or less old news since it incorporates the 0.7% real GDP contraction recorded in the first quarter of 2015. Since things have gradually improved over the last few months, Chair Yellen and most of the FOMC members are still confident a hike will happen this year.

While it may seem too early for some market participants, chair Yellen insisted that too much attention is being focused on the timing of the first increase at the expense of the entire trajectory, which should be more gradual than has been the case in previous periods of monetary tightening:

"As I've emphasized, previously, we have—absolutely do not expect to follow any mechanical 25 basis points a meeting, 25 basis point every other meeting—no plan to follow any type of

mechanical approach to raising the federal funds rate. We will evaluate incoming conditions and move in the manner that we regard as appropriate."

Since the U.S. Federal Reserve (the Fed) is inclined to clearly communicate future policy changes in advance so as to reduce potential market volatility that could result from monetary tightening, a strong signal that the Fed stands ready to end its zero interest rate policy should emanate from the July meeting.

One of the reasons the Fed could be prompted to act preemptively is that inflation, which continues to feel the transitory effect of last year's drop in crude oil prices, should start to accelerate as continued labor market improvements will eventually lead to wage pressure.

Bottom line:

Since February, U.S. yields have slowly risen in anticipation of an eventual Fed tightening. As we expect yields to continue to increase, bonds with lower durations and higher coupon rates should be favored. We remain underweight government bonds for the short-term, but see 10-year yields rising to 3% as a buying opportunity.

Inflation-linked bonds: Good relative opportunity

Since traditional bonds offer no protection against rising inflation, we think it's time to consider inflation-linked bonds (ILBs). They play a useful role in such an environment since the principal of an ILB and its underlying coupon increase with the total consumer prices index (table 2).

Here are some characteristics/points to consider before investing in ILBs:

- ILBs are also vulnerable to rate increases since they generate duration risk that is similar to their traditional counterparts. For Canadian ILBs, the duration can also be very high as they tend to have terms of 15 to 20 years. Investors must also consider that ILBs are tied to traditional bonds by the expected inflation (a.k.a. breakeven inflation rate). Right now, the yield difference between US 5-year treasury notes (1.60%) and TIPS of same maturity (0.02%) puts the break-even rate at 1.58%. Therefore, if inflation is expected to be higher (lower) than 1.58% for the next five years, then ILB are more (less) attractive as an investment than treasuries for this time period. (chart 3, next page).
- Because ILBs are linked to inflation, they offer an additional measure of diversification to a portfolio.

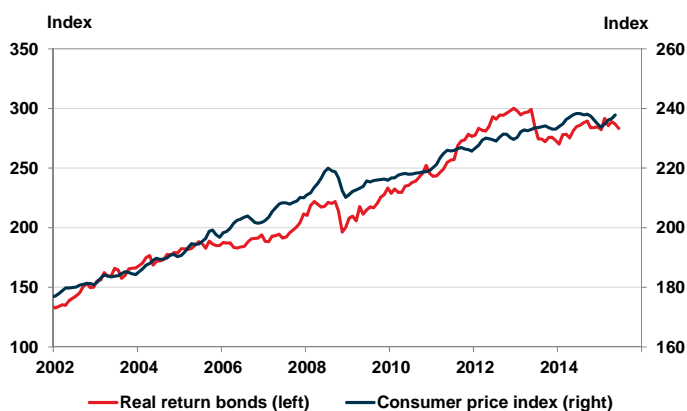
Table 2: Factors affecting inflation-linked returns

		Direction of interest rates	
		Falling	Rising
Inflation	High	<u>Best ILB environment</u> Falling real rates generate capital gains High inflation increases coupon rate and principal Economic environment Risk-averse market Flight to quality High inflation expectations Weak outlook for equities	<u>Good ILB Environment</u> Rising real rates generate capital losses High inflation increases coupon rate and principal Economic environment Risk-seeking market Good investment opportunities Rising nominal rates Tight monetary policy
	Low	<u>Good ILB Environment</u> Falling real rates generate capital gains Low inflation accruals offset by falling real rates Economic environment Risk-neutral market Capital not seeking risky investments Low inflation expectations Nominal rates steady or falling	<u>Bad ILB environment</u> Rising real rates generate capital losses Low inflation accruals reduce expected income Economic environment Risk-seeking market Abundance of investment opportunities Rising nominal rates Tight monetary policy

Source: Pimco

Bottom line:

Though commodities may also serve as an alternative to hedge against inflation, we think the strong USD environment and slowing Chinese demand are better suited to an ILB strategy. Since we believe yields are at risk of increasing during the course of the year, it would be more appropriate to switch to ILBs by reducing exposure to traditional bonds of similar duration rather than cutting back on equity weightings. (chart 4, next page).

A perfect fit

3 Source: Datastream

**Credit spreads: Not too hot, not too cold**

Even if most yields have rebounded somewhat since February, they are still considered historically very low (chart 5, next page). Generating better returns is challenging since investing in longer term bonds only generates a small yield pickup compared to shorter terms.

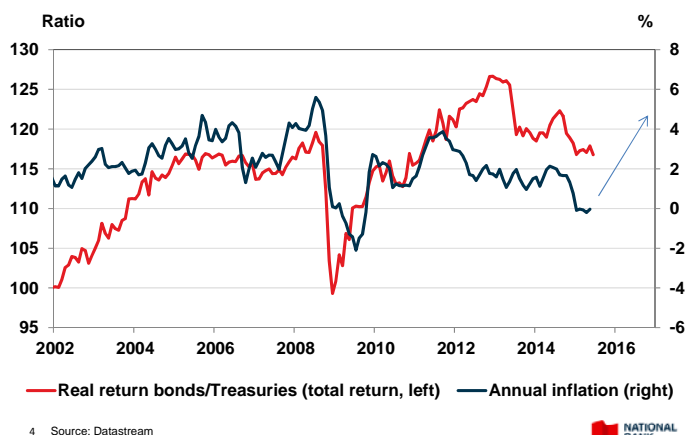
As chart 6 shows (next page), corporate and high yield bond spreads look to be in line with historical norms. We think the additional returns provided by corporate or high yield bonds make them a better place to invest the bond component of your portfolio than treasuries, since the economy is in expansion and credit risks should be well contained for the foreseeable future.

Also, high yield bonds will be better suited to a rising rate environment as the lower durations for such products make them less sensitive to interest rate risk, and they also offer some form of diversification from other bonds.

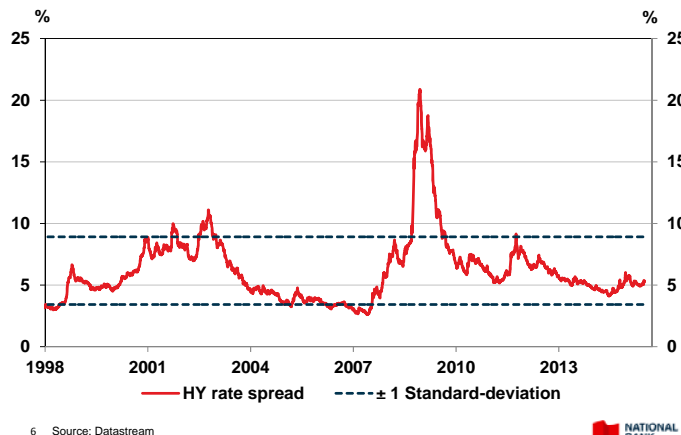
Bottom line:

Though corporate and high yield bonds are exposed to potential credit events, we think the additional yields and duration protection are worth the risk at the moment.

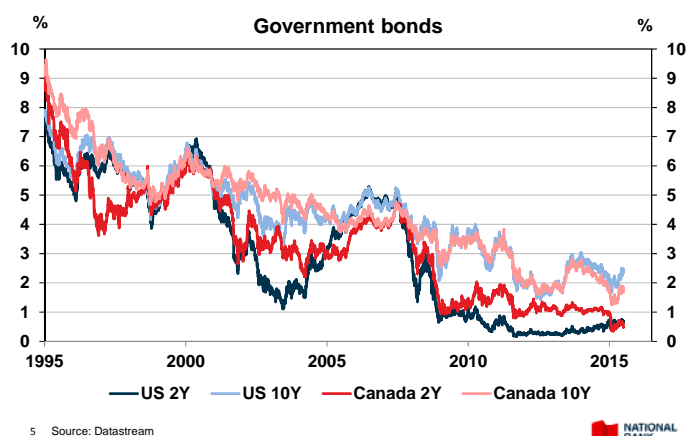
A good relative play



Right in the middle



Time for a rebound?



Equities

Though risk assets may fall victim to turbulence as a result of how the Greece /Eurozone plays out, geopolitical tensions in the Middle East or a sharp pullback in the Chinese stock market, we believe equities continue to offer good value and attractive potential returns. The risk of volatility also presents opportunities, but over the coming months there are a number of factors which could impact returns that bear watching:

- Though monetary tightening could be risky for U.S. stocks, we think this situation would be temporary (please refer to last month's AAS) since the economic backdrop continues to improve. Expectations that the Fed will tighten at a slower pace, combined with commitment to limit the surprise effects of a potential increase will certainly help diminish the adverse effects of a hike when it does happen.
- The S&P 500 forward P/E ratio now stands at 17, which is right in the middle of its historical range (chart 7). Spurred

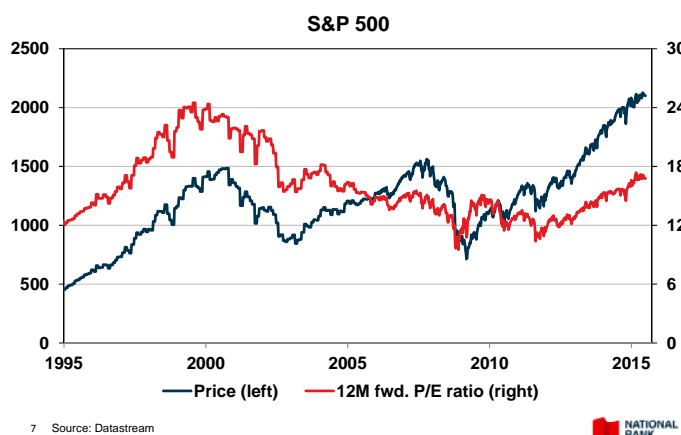
by low rates, stock returns have benefited from a certain amount of ratio expansion over the last few years. The impacts of an improving US economy are now being felt in the equity space as earnings are now being revised upwards which should help future performance.

- Technically we think the market should find support at 2050, which is the 200 day moving average (chart 8, next page). There have been brief episodes in the last two years where the market broke through this level on the downside, quickly bouncing back to its bullish trend afterwards. Even though the VIX shot up as a result of the Greece headlines, we think it should revert back fairly quickly once the initial shock is assessed by the markets.

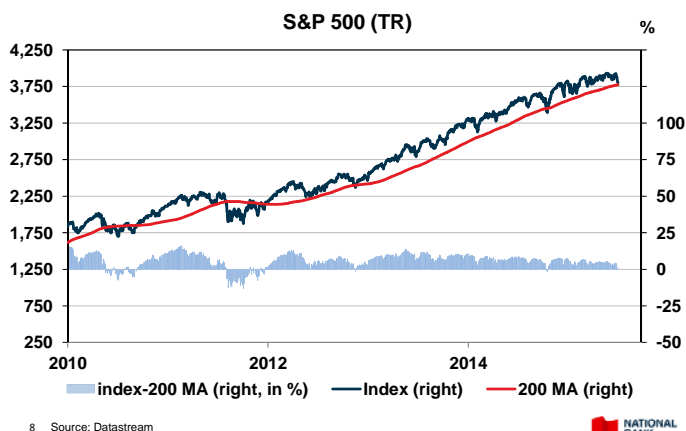
Bottom line:

We continue to favour U.S.-dollar denominated equities. The S&P 500 should resume its uptrend in the second half of the year as the economy picks up steam. European equities are the most at risk from the uncertainty linked to Greece, but a lot of bad news is already priced into current levels. Commodity-linked markets, such as the TSX, should remain neutral, at most.

Still some way to go



The moving average is a great support



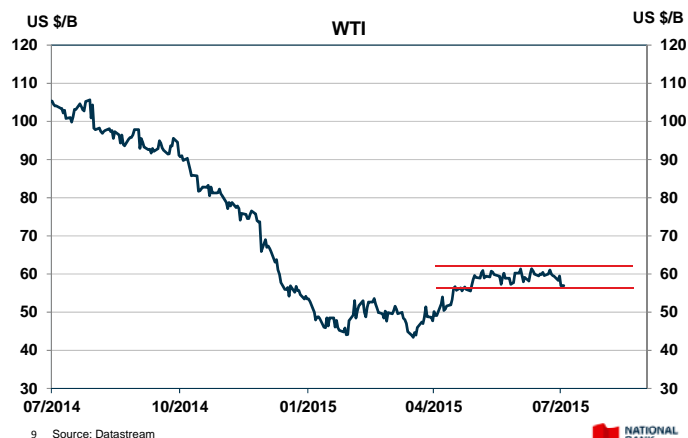
Foreign exchange

The Canadian dollar is still very much dependent on energy prices and for the last two months, the \$57-62 West Texas Intermediate price range has proven to be a formidable barrier, with ongoing seasonal inventory draw-downs pushing prices up, only to see crude producers take advantage of the uptick to sell and lock in some profits (chart 9)

Right now, it seems that equilibrium has been found, but eventually one of the following factors will win out and drive prices out of this range:

- The summer season has always been a period where crude inventories have a tendency to shrink since refiners are producing gasoline at full capacity to take advantage of good refinery margins. The main concern in the crude space is whether the drop in the number of oil rigs and its effect on production added to the seasonal draw-down will decrease inventories enough before Q4, at which point they should have a tendency to build up once again during winter. As it stands right now, any inventory draw-down similar to last year's should be interpreted as negative for the crude space (chart 10) because the surpluses accumulated last year remain in storage - which would renew fears of congestion next spring.
- The geopolitical situation is hard to assess right now since Gulf countries are always at risk of a production shortfall as a result of the war and terrorism. However, there are also chances that Iran and the P5+1 countries could come to an agreement, which would lift the oil embargo and eventually add roughly 500M to 800M barrels per day to the markets.
- Oil demand will also be highly dependent on the overall world economy since the bulk of demand growth is expected to come from Asian and emerging markets. We

Which way?



have to keep a close eye on China's economic situation and contagion risks emerging from a potential "Grexit".

Bottom line:

Oil prices may well remain within a tight range for the foreseeable future, but the upside seems limited, and we think they are still vulnerable to a downturn or increased volatility by the end of the year. We recommend staying long USD against other major currencies.

Still a lot of inventories to go through

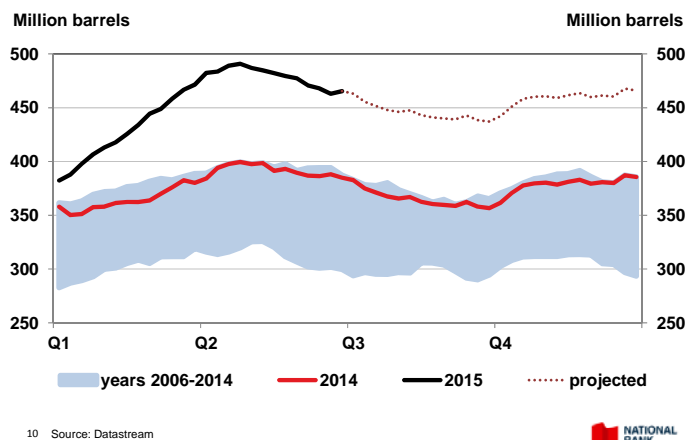


Table 3 Global Asset Allocation (Tactical vs Strategic)

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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