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Asset Allocation Strategy

Summer lull

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Market review

Supported by its Consumer (discretionary: + 4.8 %, staples: +5.5%) and Utilities (+ 6.0 %) sectors, the S&P 500 performed well, posting a return of 2.1 %. North of the border, the S&P/TSX lost 0.3 %, unable to overcome the drag from its heavy commodity weighting - Materials and Energy fell by 14.5 % and 6.5% respectively.

The yield for U.S. 10-year treasuries yield fell by 0.12 % to reach 2.21 % while Canadian 10-year bond yields dropped 0.25% to 1.44%. The 0.25% target rate cut implemented by the Bank of Canada (BoC) is the main reason the Canadian dollar weakened by 6 cents this month compared to its U.S. counterpart.

Asset allocation strategy

- While acknowledging that lower rates may also exacerbate record household debt levels, the BoC remains confident that the weaker Canadian dollar, its effect on exports and ongoing U.S. growth will help get the economy back on track by the end of the year.
- Fed Chair Janet Yellen expects that a rate increase will be appropriate at some point later this year if conditions continue to improve at the current pace.
- We feel that the Fed's transparency with regards to normalization and the expected very gradual pace of eventual rate increases will not impact the performance of equities in a meaningful way.
- We remain underweight government bonds for the short-term, but would see 10-year yields rising to 3% as a buying opportunity.

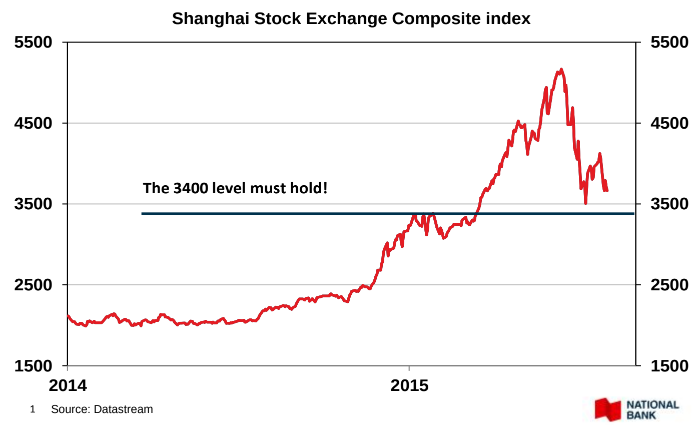
Table 1 Market total returns

Asset classes	July	YTD	12-mths
Cash (3-month T-bills)	0.1%	0.5%	0.9%
Bonds (Dex Overall Universe)	**1.4%**	**3.8%**	**7.1%**
FTSE/TMX Federal	1.3%	3.4%	6.2%
FTSE/TMX Corporate	0.9%	3.1%	5.3%
FTSE/TMX BBB	1.1%	3.4%	5.7%
BoAML High-Yield (USD)	-0.6%	1.9%	0.2%
World equity MSCI (USD)	**0.9%**	**3.9%**	**3.4%**
S&P/TSX	-0.3%	0.6%	-2.9%
S&P/TSX Small cap	-6.4%	-5.5%	-19.7%
S&P500 (USD)	2.1%	3.4%	11.2%
Russell 2000 (USD)	-1.2%	2.8%	10.6%
MSCI EAFE (USD)	2.1%	8.1%	0.1%
MSCI EM (USD)	-6.9%	-4.0%	-13.1%
Commodities (CRB index)	**-3.7%**	**-6.3%**	**-16.0%**
WTI oil (US$/barrel)	-21.0%	-12.9%	-52.2%
Gold (US$/ounce)	-6.4%	-7.8%	-14.9%
Copper (US$/tonne)	-9.3%	-18.0%	-26.8%
Forex (DXY - US Dollar index)	**1.9%**	**7.8%**	**19.5%**
USD per EUR	-0.8%	-8.7%	-17.4%
JPY per USD	1.2%	3.5%	20.6%
CAD per USD	4.8%	12.6%	20.0%

Source: Datastream * 7/31/2015

CHART OF THE MONTH

At a crossroads



Quick takes

Like a bull in a china shop

Dogged by excessive speculation and weaker than expected growth, Chinese stocks entered a volatile downward correction phase. Though the market is still well above 2014 levels (chart of the month), its recent precipitous drop prompted the Chinese government step in and implement a slew of actions to stop the bleeding. These include:

- Lowering rates to stimulate the economy;
- Applying pressure on different government organisations and state-held financial institutions to stop selling stocks, encourage stock buying and extend loans to help with margin requirements;
- Relaxing rules on margin financing;
- Strongly "encouraging" brokerage firms to buy blue chip stocks and not sell equities;
- Putting a halt on planned IPOs;
- Banning the disposition of stocks by shareholders who own stakes of more than a 5% in companies.

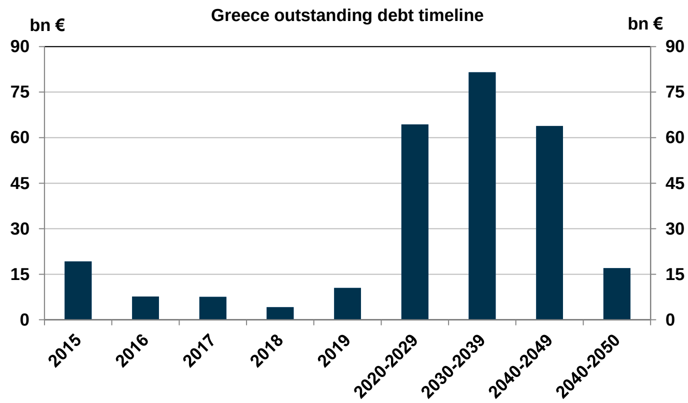
Though markets remain jittery, the government seems to have succeeded in putting a floor under prices. On average, most of the losses investors have incurred since June are more than offset by the gains they have enjoyed since 2014. In addition, equities account for only about 9 percent of household wealth in the country - this correction is unlikely to affect the economy that much since only a minority of the Chinese are exposed to it.

In light of the limited damage resulting from the drop, Beijing's heavy-handedness is puzzling. The government may have been prompted to act to preserve credibility, since in the recent past party officials have been using the stock market's stellar performance as proof that the economic reforms they have implemented are delivering the goods. If stocks keep plummeting, the damage may well be more political than financial. Technically, should stocks resume their downtrend the Shanghai Index should find some support around the 3400 level.

Greece: crisis averted?

On July 13th, the Greek Prime Minister finally accepted creditor's demands in order start negotiations to secure the country's third bailout, which will amount to 86 billion euros. The agreement calls for easier payment terms on Greece's existing debt (chart 2) and a stimulus plan, in exchange for a wide array of measures such as pension cuts, tax increases and increased international scrutiny of government expenses. The possibility of a "Grexit" is now reduced but difficult negotiations on the details of the agreement, especially regarding the sustainability of the Greek debt, still lie ahead.

A long road ahead



2 Source: http://graphics.wsj.com/greece-debt-timeline/

Iran: new business as usual

The Iran deal with the P5+1 countries is basically a gradual lift of economic sanctions imposed on the country in exchange for strict limits and monitoring on its nuclear enrichment capacity. The geopolitical impact of this agreement will take time to pan out as this is a complex region of the world, and the situation remains fluid. Economically, the gradual lifting of the embargo means that world's 6th largest oil producer will eventually participate in the world's crude supply chain and compete with Russian oil for market share in Europe and Asia.

Commodities: stuck in a negative feedback loop

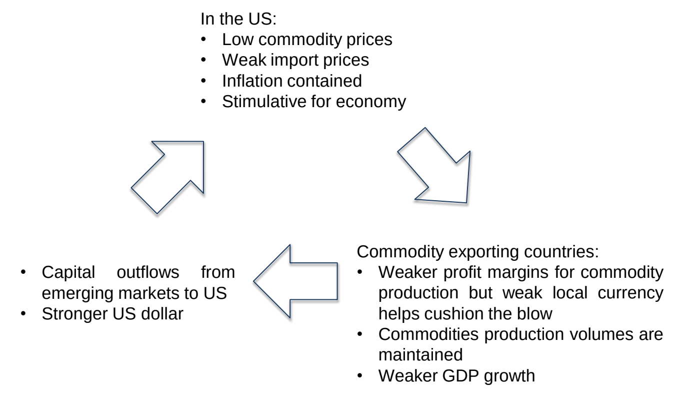
This summer marks the one-year anniversary of the infamous rout in the energy markets. Nothing says happy birthday like an Iranian deal that is likely to exacerbate the already weak supply and demand picture for oil. While producers certainly adapted by cutting costs and disinvesting in future projects, it seems prices have not dropped enough to justify material production cuts. All eyes are now on the end-of-summer inventory projections and the potential risk of fall/winter storage congestion in the U.S. once refineries enter their seasonal maintenance period in September.

However, the crude oil situation is just part of a bigger commodity collapse. Base metals are also suffering from decelerating demand from China, since this country is experiencing a slowdown and transitioning from investment-intensive growth to a more consumer-based economy.

Low commodity prices help contain inflation and strengthen the U.S. recovery, which in turn helps the greenback appreciate since markets expect the Fed to eventually raise rates. As such, commodity exporting countries can maintain a certain level of profit margin, because production costs are in local currency while the selling occurs in USD-denominated terms. However weaker GDP growth in those countries, particularly in emerging markets, is triggering capital outflows with U.S.-based investments being the main beneficiary. This strengthens the U.S. dollar and puts additional downward pressure on commodity prices.

This negative feedback loop (chart 3) will eventually end when prices fall to a level so low that production is curtailed in a material way, or that a rebound in demand is triggered.

Negative Feedback loop



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Gold: additional causes for the malaise

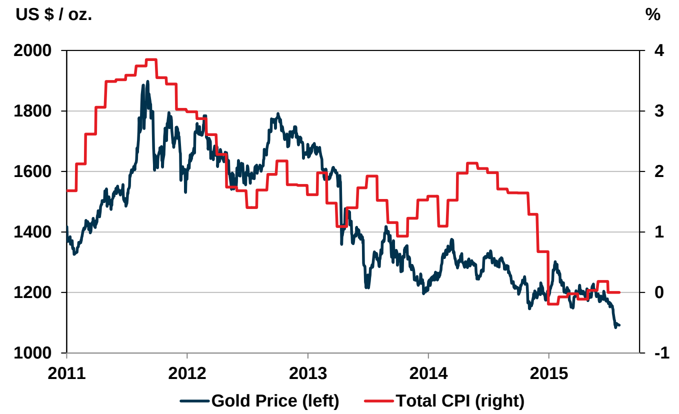
Gold has always been considered a special case in the investment space since it is a hybrid product situated between commodities and currencies. As such, it is subject to additional factors that influence the direction of prices. The slow erosion in the price of bullion since its 2011 peak is certainly fraying the nerves of even the most patient investors, particularly given the 15% drop since mid-January. While gold is certainly suffering for the reasons we listed above, there are some additional factors behind the recent downtrend:

1- In a span of a couple of weeks, some of the pressures contributing to economic instability subsided materially - "Grexit" has been averted and Iran reached an agreement with the P5+1 countries. Gold has always been considered a safe haven in times of political or economic turbulence and these two deals removed one of the reasons for owning gold as a store of value.

2- The People's Bank of China is trying to diversify its reserves beyond its massive U.S. dollar holdings. Since owning gold is considered to be a way of doing so, China has been one of the main buyers of the yellow metal. On July 17th, the bank disclosed official gold holdings of 1658 tons compared to 1054 tons in April 2009, falling well short of market expectations that called for holdings closer to the 2800 ton level. This disappointing number added to the already bearish undertone for gold.

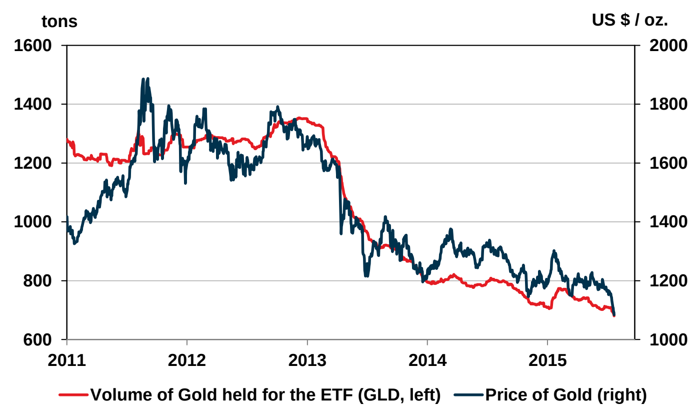
3- Gold has always been considered as a hedge against inflation, and since inflation has been subdued for quite some time, bullion has lost some of its lustre (chart 4), causing retail investors to look elsewhere. Gold does not pay any dividends or interest, and the retail market has been dumping gold ETFs (chart 5), given that stocks and bonds offer more attractive prospects at similar or lower levels of volatility.

No inflation = no performance



4 Source: Datastream

Retail clients are selling



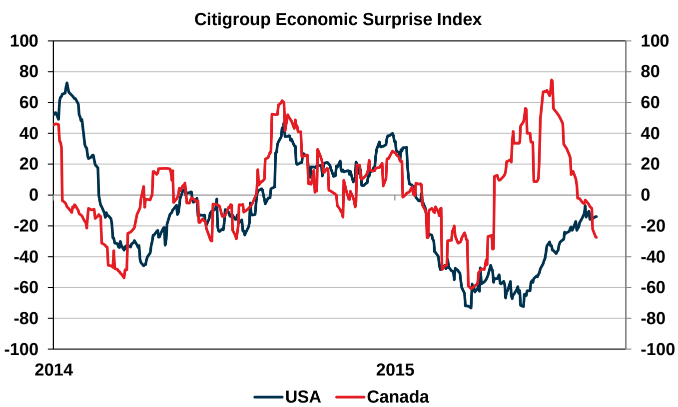
5 Source: Datastream

If the price of gold continues on its downward trajectory, there will be an increased focus on production costs which could result in project cancellations. Since the majority of gold producers operate with cash costs under $800/oz. we should not expect major cuts in supply unless spot prices trade around or below that level for a certain amount of time.

Canada and U.S. economies: desynchronized

The economic situation in the two countries couldn't be any more different at the moment (chart 6) and the positioning of their respective central banks reflects this.

Two desynchronized economies



6 Source: Datastream

On the Canadian side, Mr. Poloz used the lingering impact of the downturn in commodity prices and the lack of investment spending in the space to justify a 0.25% drop in target rates:

"Since our last MPR in April, global economic developments have been quite disappointing, and these have led to a significant downgrade of our estimate of Canadian economic growth for 2015. There were three factors behind this downgrade:

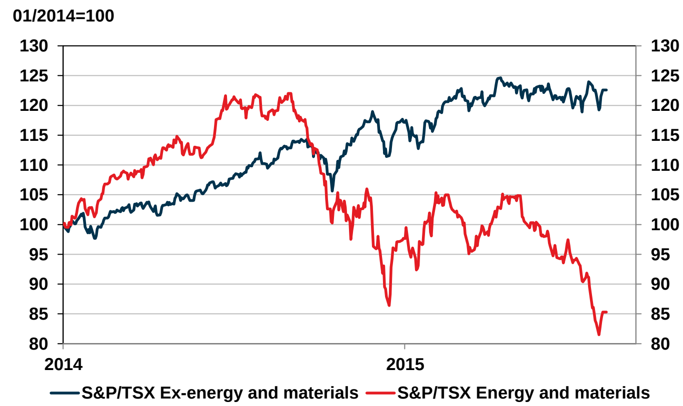
First, Canadian oil producers have lowered their long-term outlook for global oil prices, and have cut their plans for investment spending significantly more than previously announced.

Second, China's economy is undergoing a structural transition to slower, domestic-driven growth, which is reducing Canadian exports of a range of other commodities.
Third, Canada's non-resource exports have also faltered in recent months. While this is partly due to the first-quarter setback in the U.S. economy, it's still a puzzle that merits further study.

Given the collapse in oil prices, and declines in some other key non-energy commodities, the economy is now operating on two distinct growth tracks: the resource track and the non-resource track."

Those two "growth tracks" are very apparent looking at the Canadian stock market where the Energy and Materials sectors have been the worst performers year-to-date (chart 7). Mr. Poloz mentioned that if the commodity sector is excluded, 82% of our economy is still growing at a decent 2% and that since the downturn is localized, there is no reason to focus on the "recession" word.

Two distinct growth tracks

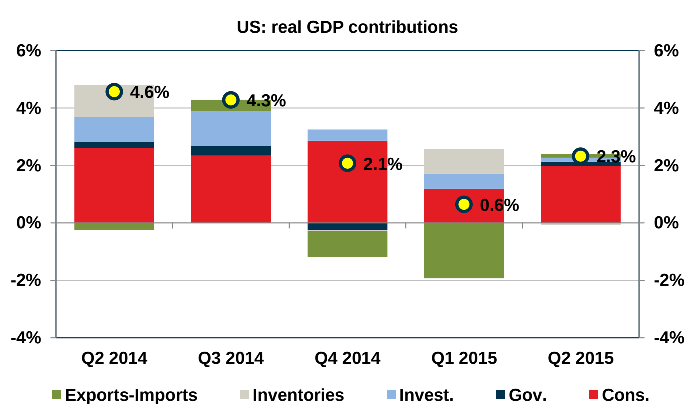


7 Source: Datastream

While acknowledging that lower rates may also exacerbate record household debt levels, the BoC remains confident that the weaker Canadian dollar, its effect on exports and ongoing U.S. growth will help get the economy back on track by the end of the year.

The prospects are better south of the border, with advance estimates for Q2 GDP growth coming in at +2.3% (chart 8), putting the bad winter numbers in Q1 solidly behind us. As of right now, risks to the global economies and weak exports caused by the strong US dollar would call for patience with normalization. However, job gains are continually improving the underemployment metrics (chart 9, next page) and the Fed anticipates annual inflation to rise gradually towards its 2% target over the medium term. Consequently, Fed Chair Janet

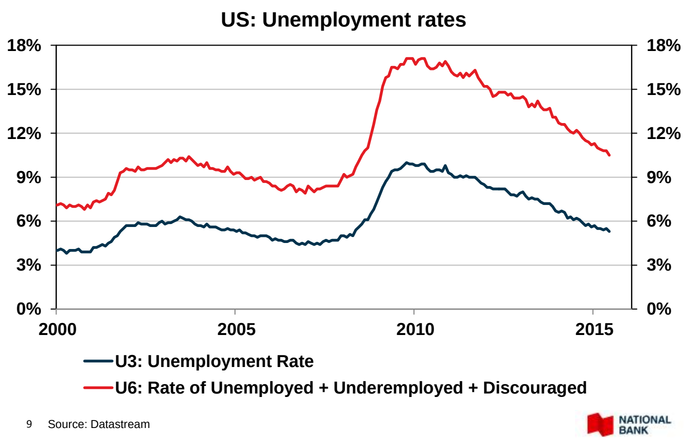
Decent Q2 numbers



8 Source: Datastream

Yellen expects that a rate increase will be appropriate at some point later this year if conditions continue to improve at the current pace.

US employment: constantly improving



Asset Allocation

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 American economy continues to pick up steam. We feel that the Fed's transparency with regards to normalization and the expected very gradual pace of eventual rate increases will not impact the performance of equities in a meaningful way. European stock markets rebounded after Greece stuck a deal with its creditors, and we think the reduced uncertainty will bode well for future returns since the focus has now shifted to growth, and the European Central Bank policy remains accommodating. The outlook for commodity-linked markets such as the TSX should remain neutral at best.

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

Table 3 Global Asset Allocation (Tactical vs Strategic)

3-month horizon

Asset classes	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		■			

12 to 18-month horizon

Asset classes	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