

# Asset Allocation Strategy

## Chinese puzzle

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### Market review

Rattled by uncertainty about the Chinese devaluation of the Yuan and the bursting of its stock market bubble, the S&P 500 entered correction territory but rebounded late in the month to record a loss of -6.0%, which is the worst monthly performance since September 2011. Volatility didn't spare the S&P TSX which recorded -4.0%.

The US dollar index lost 4.1% at the height of the panic as investors were expecting the Fed to postpone its monetary tightening, but as the market caught its breath, it bounced back to post -1.6% for the month.

### Asset allocation strategy

- There is uneasiness about the way the Chinese authorities are handling the popping of their stock market bubble. By itself, the correction in the Shanghai Index is meaningless for world equities at large and the average Chinese consumer, as it only represents a tiny fraction of household assets.
- Overall, we think the question investors must ask themselves is: are the developed market economies solid enough to withstand a Chinese deceleration? We think the answer is a cautious "yes" -- for now.
- In light of the recent events stemming from China, and stock market volatility, we think it is wise to maintain a little bit of extra cash while we wait for the dust to settle and we get more clarity about the situation.
- In the U.S., we prefer mid-caps over their larger counterparts, as we think they are best positioned to take advantage of domestic growth, and are also more insulated from volatile international markets and lower foreign profits caused by a strong U.S. dollar.
- We prefer an allocation towards developed market equities over their emerging market counterparts.

Table 1 Market total returns

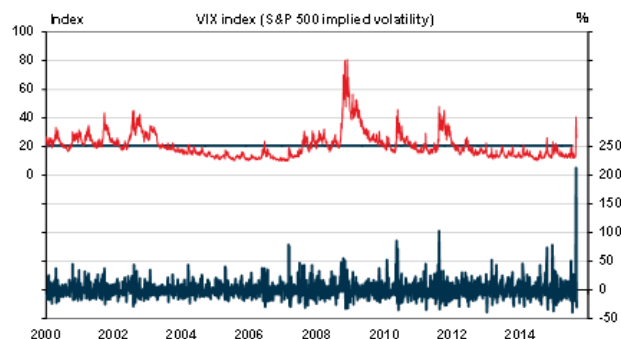
Asset classes	August	YTD	2014
<b>Cash (3-month T-bills )</b>	0.0%	0.5%	0.9%
<b>Bonds (Dex Overall Universe)</b>	<b>-1.0%</b>	<b>2.8%</b>	<b>8.8%</b>
FTSE/TMX Federal	-0.4%	3.0%	6.9%
FTSE/TMX Corporate	-1.0%	2.1%	7.6%
FTSE/TMX BBB	-1.2%	2.2%	9.0%
BoAML High-Yield (USD)	-1.8%	0.1%	2.5%
<b>World equity MSCI (USD)</b>	<b>-6.8%</b>	<b>-3.2%</b>	<b>4.7%</b>
S&P/TSX	-4.0%	-3.5%	10.6%
S&P/TSX Small cap	-2.7%	-8.0%	-2.3%
S&P500 (USD)	-6.0%	-2.9%	13.7%
Russell 2000 (USD)	-6.4%	-3.8%	3.5%
MSCI EAFE (USD)	-7.3%	0.1%	-4.5%
MSCI EM (USD)	-9.0%	-12.6%	-1.8%
<b>Commodities (CRB index)</b>	<b>-1.0%</b>	<b>-7.2%</b>	<b>-4.1%</b>
WTI oil (US\$/barrel)	3.6%	-9.7%	-45.4%
Gold (US\$/ounce)	3.3%	-4.7%	-1.8%
Copper (US\$/tonne)	-1.4%	-19.2%	-13.7%
<b>Forex (DXY - US Dollar index)</b>	<b>-1.6%</b>	<b>6.1%</b>	<b>12.8%</b>
USD per EUR	1.4%	-7.4%	-12.2%
JPY per USD	-2.2%	1.3%	13.7%
CAD per USD	0.4%	13.1%	9.4%

Source: Datastream

8/31/2015

### CHART OF THE MONTH

#### The end of complacency



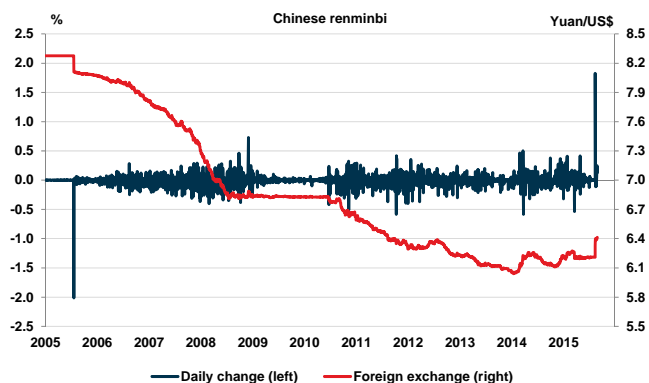
1 Source: Datastream

NATIONAL BANK

### China sneezed and stocks caught a cold:

Just as financial markets were digesting the final act of the Greek tragedy and thinking that bluer skies were ahead of them, the Chinese government, in a pre-emptive effort to buy some flexibility before a Fed rate hike, unexpectedly decided to devalue its currency by 2% (chart 2). This action triggered a chain of events, culminating in a worldwide equity rout and extremely volatile markets. Though the Yuan devaluation is considered as the starting point of the correction, we think the downturn is caused by multiple factors that accumulated over the last few months:

### Devaluation was a policy mistake

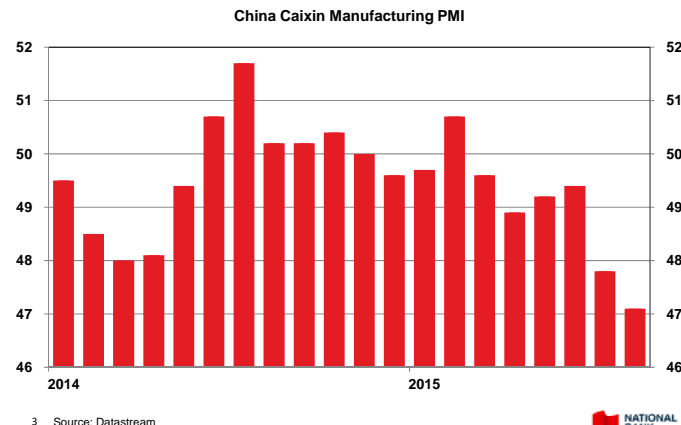


2 Source: Datastream



- Economists are very skeptical about numbers published by the Chinese government. Even the official Chinese GDP growth numbers showing an annual increase of 7% for Q2 seem too good to be true, especially when other economic indicators depict a much less rosy picture (the fact that the published number falls right on the target set by officials just adds to the irony of it all). For example, the manufacturing Purchasing Managers' Index (PMI) has shown figures lower than 50 since March (chart 3), which would indicate a contraction for the sector since then. Exports were also weaker than expected in July, posting a decrease of 8.3% year-over-year (vs. 1.0% for market expectations). As a consequence, the extent of the deceleration in the Chinese economy is more difficult to assess and left to interpretation, and investors will have to rely on different factors such as PBOC actions or more tangible sources for confirmation about the status of the economy.
- One source is commodity prices which have been underperforming since mid-2014. Although most of the problems dogging the sector can be attributed to USD strength or over-supply (especially in energy space), some market participants are, in our view, mistakenly tying the

### The transition to consumer-based economy is difficult



drop solely on reduced Chinese demand and economic activity.

- The resulting drop in base material prices has been very painful for emerging markets, commodity-linked economies, and their respective currencies thus increasing both deflationary risks across the globe and credit risks in emerging countries as some of their debt is denominated in U.S. dollar terms. Their faltering economies trigger capital outflows to developed markets which weaken their currency even more. The fact that China devalued the Yuan is interpreted by some as the start of a "currency war" where central banks are trying to weaken their respective exchange rates to stimulate the economy and boost exports.
- There is uneasiness about the way the Chinese authorities are handling the popping of their stock market bubble. By itself, the correction in the Shanghai Index is meaningless for world equities at large and the average Chinese consumer, as it only represents a tiny fraction of household assets. The timing couldn't be worse as leaders are pushing the necessary-but-difficult transition from an investment-led economy towards a more consumer-based one. Though the equity crash is not necessarily a good barometer of the overall Chinese economy, the kitchen sink approach used by the government to stabilize markets has created a crisis of confidence and spooked investors into thinking the situation may be worse than it really is. The fifth monetary easing action by the PBOC since November 2014 doesn't help in alleviating those fears.

In this context, we can now understand how the Yuan devaluation was badly received; it effectively became the straw that broke the camel's back. The mixed signals sent by the government are continually keeping the financial markets guessing about its real intentions with regard to opening up its markets. On one hand, officials insisted the motivation behind

the Yuan devaluation was to allow market forces more influence in setting the currency's value and to eventually become a reserve currency but, on the other hand, they foolishly tried everything in their power to prop up a falling stock market (chart 4). Is the Yuan devaluation really about currency reserve status or is China temporarily putting economic reforms on hold and trying to boost exports? As the world's second biggest economy, this situation becomes difficult to manage for investors worldwide as confusion breeds volatility, and it will remain that way until a clearer picture emerges.

### Policy intervention for equities: Can't stop gravity

- ☑ PBoC liquidity support via China Securities Finance Corporation (CSFC)
  - Provide margin financing loans to qualified securities companies
- ☑ State financial institutions increase investment
  - 21 big brokerage firms bought CNY128B shares on July 6
- ☑ Ministries pledge not to sell and SOEs pledge to buyback shares
- ☑ Administrative measures taken to limit the fall
  - IPOs suspended indefinitely
  - Collateral requirements were raised for sellers in the futures market
- ☑ Currency devaluation
- ☑ State-owned pension fund allowed to buy stocks (30 % of assets)
- ☑ Lower reserve requirement ratio
- ☑ Lower lending and deposit rates

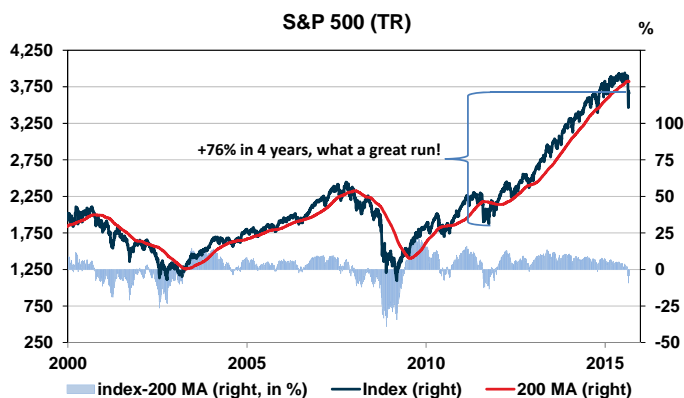
US\$400B...  
... so far!



### Developed market equities: a correction, not a crisis

The equity rout didn't spare the S&P 500, as it swiftly entered a correction phase in the wake of the Chinese news. Though worrisome, one must understand that the run of great returns with little volatility we have witnessed since the end of the financial crisis in 2009 is the exception, not the norm (chart 5). Usually a correction occurs once a year and the index hasn't witnessed or didn't experience any since 2012. So, in

### The exception, not the rule



5 Source: Datastream

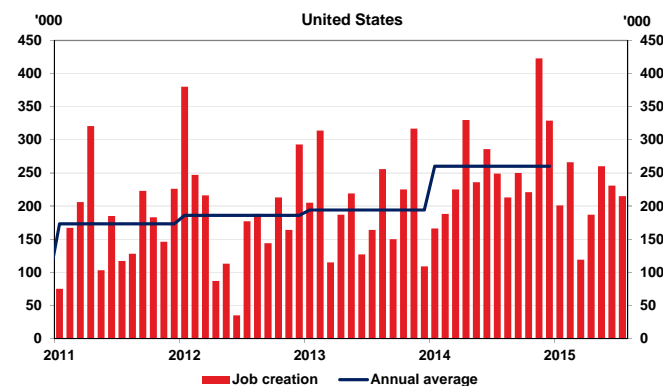


retrospect, it seems the market was ripe for some form of downturn and the Asian news was the perfect trigger. When investors get used to calm waters, complacency sets in. Shocks can be more brutal as panic takes center stage and when sound analysis is forgotten.

Here are some reasons we think the downturn is temporary and stocks will eventually stabilize and rebound:

- The panic set in motion by Chinese equities is, by itself, close to irrelevant to developed market equities and economies; even if economically the country may be decelerating and has a certain impact on worldwide economies, we think the situation is far from being important enough to put in peril global growth projections. For example, the Eurozone manufacturing PMI is standing at 52.4 in August while the services PMI recorded 54.3 for the month.
- The U.S. economy is still growing at a good pace, with their Q2 GDP revised to a very solid 3.7% (annualized), and employment constantly improving (chart 6).
- Though the most obvious risk may be the contagion to create an Asian financial crisis re-dux, we think the Asian markets are now better equipped to face such an occurrence (chart 7, next page).

### Labor market slowly climbing back towards 2014 highs



6 Source: Datastream



Overall, we think the question investors must ask themselves is: are the developed market economies solid enough to withstand a Chinese deceleration? We think the answer is a cautious "yes" -- for now. The correction may well be a blessing in disguise as complacency is now giving way to a deeper analysis of the Chinese situation as well as an increased focus on risk management.

## Asian crisis: 1997-98 vs. 2014-15

### Similarities

- Low real interest rates
- Domestic misallocation
- Debt build-up
- Rising US key rates
- Strong US dollar

### Differences

- Low inflation environment
- Build-up in debt more domestic than external, and denominated in local currency
- Debt raised by public sector rather than by the corporate sector
- Most EM countries run a current account surplus
- Higher foreign reserves to short-term debt coverage ratio
- More flexible exchange rates
- US monetary tightening should be modest and gradual

7



## A study about the aftermath of violent corrections

Though we enumerated various qualitative and economic reasons for which we think the markets will stabilize, there's also a compelling case to be made about studying past corrections. While we are aware that each situation has its own sets of characteristics, this analysis can be useful as it gives some insight as to how markets react to an event similar to what we have just witnessed. In order to be included in the list below, past events had to have shown an S&P 500 drop of 10% or more within 5 or fewer trading days since 1985. Brace yourselves as we enter the museum of horrors.

### 1. Black Monday (October 1987):

The S&P 500's worst 5-day loss: **-27.7% (19-Oct-1987)**

Performance 3 months following the worst loss: **+10.9%**

Performance 6 months following the worst loss: **+14.7%**

This is the boogeyman every old timer talks about to young stock traders. The crash marked the end of a five-year bull run but the causes for the move remain nebulous. Fingers point towards computer trading in illiquid markets (yes, even in 1987 computers were taking the blame), derivatives trading, and overvaluation of stocks. While none of these reasons can individually explain the crash, their combination, added to market panic, becomes a more plausible hypothesis.

### 2. Russian financial crisis (August 1998):

The S&P 500's worst 5-day loss: **-12.0% (31-Aug-1998)**

Performance 3 months following the worst loss: **+21.6%**

Performance 6 months following the worst loss: **+34.4%**

Russia was dealing with public turmoil, chronic fiscal deficits, declining productivity, and decreasing crude prices. The Russian government tried to defend the ruble's value to prevent flight of capital by fixing a trading ban on the currency,

and the country's central bank was expending tremendous amounts of U.S. dollars to defend that peg. The situation became untenable and, in August 2008, the government devalued the ruble and defaulted on its debt.

### 3. Dot-Com collapse (2000-2002):

The S&P 500's worst 5-day loss: **-11.5% (23-Jul-2002)**

Performance 3 months following the worst loss: **+12.3%**

Performance 6 months following the worst loss: **+11.2%**

This tumultuous period was witness to a *bona fide* high-tech bubble bursting, a terrorist attack, and an accounting scandal (Enron). As the internet was becoming recognized as a new way to conduct business, investors and speculators thought the potential for companies within the sector was limitless. Let's put an emphasis on "potential" here, as technology stocks benefitted from a toxic mix of speculation, easy access to venture capital, and complete disregard for proper equity valuations. The day of reckoning came when some of these companies failed to deliver on their promising futures and eventually declared bankruptcy. The bursting of the high-tech bubble was also tied to a brief U.S. recession.

### 4. The 9/11 terrorist attack (September 2001):

The S&P 500's worst 5-day loss: **-11.6% (21-Sep-2001)**

Performance 3 months following the worst loss: **+18.5%**

Performance 6 months following the worst loss: **+19.4%**

The stock exchange re-opened on September 17, 2001, after the worst terrorist attack ever perpetrated on U.S. soil. Fears of additional attacks, coupled with uncertainty about insurance claims and air travel's apparent lack of security, pushed stocks down.

### 5. Great Recession/Financial Crisis (2008-2009):

The S&P 500's worst 5 day loss: **-18.3% (9-Oct-2008)**

Performance 3 months following the worst loss: **-2.2%**

Performance 6 months following the worst loss: **-5.9%**

Considered the greatest crisis since the 1930s, this financial crisis threatened the collapse of the financial system. Institutions were loading up on complex mortgage-backed securities and collateralized debt obligations, as they were offering better potential returns than traditional bonds. As the real estate bubble burst, it became clear that those assets were clearly mispriced and much more risky than previously anticipated. As a result, the value of the massive holdings held by over-leveraged financial institutions came crashing down, risking their solvency, triggering a credit/liquidity crisis that required a government bailout, bankrupting some institutions, and generating a worldwide recession whose residual effects are still being felt today.

## 6. European sovereign debt crisis (August 2011):

The S&P 500's worst 5 day loss: **-13.0% (8-Aug-2011)**

Performance 3 months following the worst loss: **+14.0%**

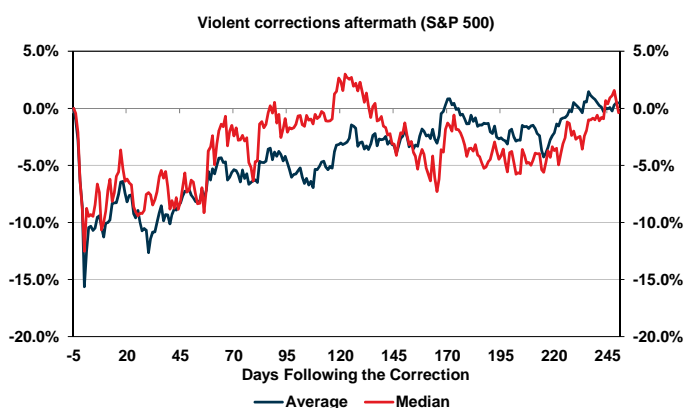
Performance 6 months following the worst loss: **+20.6%**

In the wake of the financial crisis of 2009, bond markets were troubled about the solvency of certain European countries, as their respective deficits and debt levels exploded to levels that were deemed unsustainable. There were also fears about contagion to other countries should one country enter default. Bad stock performances were also attributed to a U.S. Treasury bond downgrade from its AAA status and, before that, a serious debt-ceiling crisis between congress and President Obama.

**Conclusion:** After going through the list, it's hard to argue that the present situation is of the same magnitude as the six examples we've just presented. In the events cited above, it took 170 business days, on average, for the Index to recoup the respective losses which, considering how dire the economic/political/financial environments were during these periods, was a fairly short timeframe (chart 8).

While we agree that news about China is somewhat worrying and deceleration must stop before the situation gets out of hand, we think the major factor currently affecting markets is a crisis of confidence in the Chinese leadership. We are still far from a generalized recession, and the officials still have a lot of tools at their disposal to redress the situation politically and economically (chart 9).

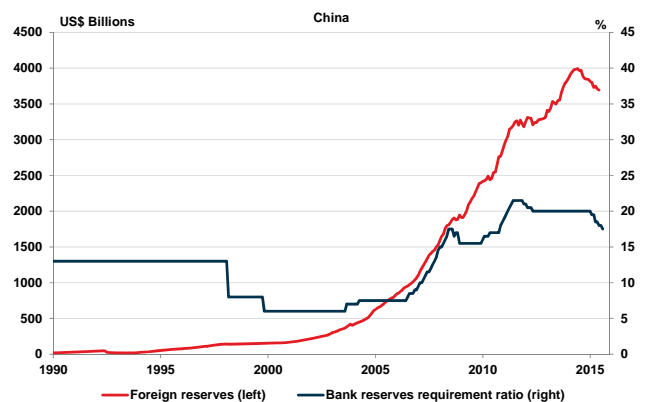
### A steady trend



8 Source: Datastream



### A whole lot of dry powder if needed



9 Source: Datastream



## Asset Allocation

### Short term:

In light of the recent events stemming from China, and stock market volatility, we think it is wise to maintain a little bit of extra cash while we wait for the dust to settle and we get more clarity about the situation.

In the U.S., we prefer mid-caps over their larger counterparts, as we think they are best positioned to take advantage of domestic growth, and are also more insulated from volatile international markets and lower foreign profits caused by a strong U.S. dollar.

We also advise keeping Canadian equities to neutral/underweight as energy products are still not out of their overproduction cycle.

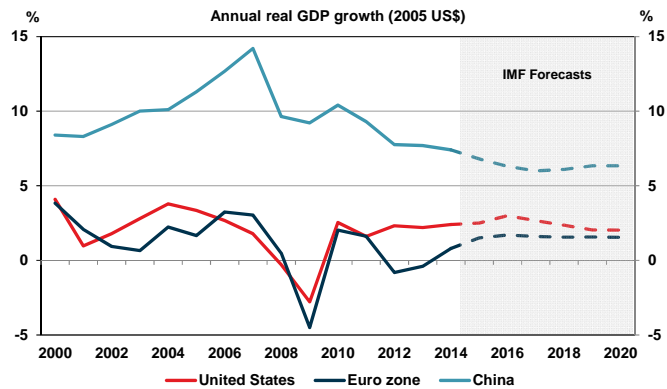
The greenback had a great run but we think a very gradual hedging back to Canadian-dollar-denominated assets is advisable.

### Medium/long term:

We think the deceleration of Chinese growth will not impact growth in the U.S. and other non-commodity related developed markets in any material way. However, we think emerging markets are at risk of further contraction as they are more exposed to a slowdown, a high U.S. dollar, and increased credit risks. As such, for equities, we would prefer allocation toward developed market equities over their emerging market counterparts (chart 10, next page).



### Growth acceleration: Dm over EM



10 Source: Datastream



On the bond side, we expect yields to increase in anticipation of eventual Fed tightening. 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 that are rising to 3% as a buying opportunity.

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		■			
<b>Bonds</b>		■				<b>Bonds</b>		■			
(Duration)			■			(Duration)		■			
Federal		■				Federal	■				
Investment grade			■			Investment grade		■			
High yield (USD)				■		High yield (USD)				■	
Non-traditional income				■		Non-traditional income				■	
<b>World equities</b>				■		<b>World equities</b>				■	
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)		■			
<b>Alternative investments</b>			■			<b>Alternative investments</b>			■		
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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