INVESTING

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Asset Allocation Strategy

Comeback kid

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Market review

October proved red hot for U.S. equities as the S&P 500 posted a return of +8.4%, which marks the best month since October 2011. All sectors were in the black, which is a tribute to the market's breadth. Materials posted an impressive +13.5% return while energy recorded +11.4%, which is much needed relief for the two worst performers YTD. The S&P/TSX didn't perform quite as well (+3.1%), as the index was weighed down by its healthcare sector (-45.8%).

Fear eventually receded as markets stabilized and the VIX decreased by 9.4% to close the month at 15.10%. 10-year U.S. treasury yields increased by 0.1% to close the month at 2.2%, while the Canadian dollar strengthened by 2.3 cents.

Asset allocation strategy

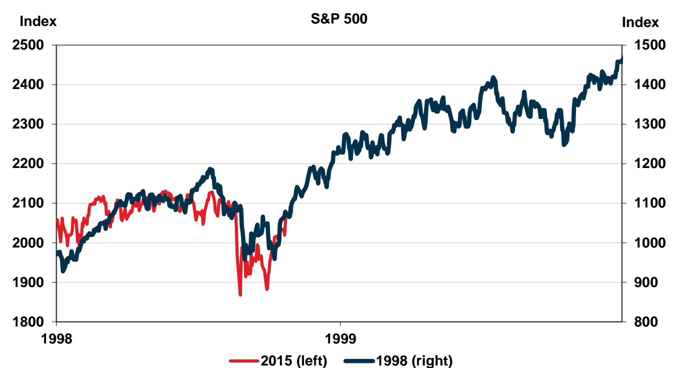
- December is still in the cards for normalization, barring any unforeseen events… but the pace of tightening will be much more gradual than previous tightening periods, which should reassure investors.
- ECB President Mario Draghi hinted that more action and further cuts could be on the way. Words are sometimes as powerful as actions when markets need to be reassured, and the dovish tone taken by Mr. Draghi should help boost investor confidence in the ECB's seriousness for action in stimulating growth.
- We advise keeping Canadian equity exposure neutral/underweight, since energy products have still not emerged from their overproduction cycle.
- 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.

Table 1 **Market total returns**

Asset classes	October	YTD	2014
Cash (3-month T-bills)	0.0%	0.6%	0.9%
Bonds (Dex Overall Universe)	**-0.3%**	**2.3%**	**8.8%**
FTSE/TMX Federal	-0.4%	2.6%	6.9%
FTSE/TMX Corporate	-0.4%	1.6%	7.6%
FTSE/TMX BBB	-0.5%	1.6%	9.0%
BoAML High-Yield (USD)	2.7%	0.1%	2.5%
World equity MSCI (USD)	**7.9%**	**0.7%**	**4.7%**
S&P/TSX	2.0%	-5.2%	10.6%
S&P/TSX Small cap	4.5%	-10.4%	-2.3%
S&P500 (USD)	8.4%	2.7%	13.7%
Russell 2000 (USD)	5.6%	-3.6%	3.5%
MSCI EAFE (USD)	7.8%	2.5%	-4.5%
MSCI EM (USD)	7.1%	-9.2%	-1.8%
Commodities (CRB index)	**-2.0%**	**-9.7%**	**-4.1%**
WTI oil (US$/barrel)	2.6%	-13.8%	-45.4%
Gold (US$/ounce)	2.4%	-3.8%	-1.8%
Copper (US$/tonne)	-0.9%	-19.4%	-13.7%
Forex (DXY - US Dollar index)	**0.6%**	**7.4%**	**12.8%**
USD per EUR	-1.0%	-8.7%	-12.2%
JPY per USD	0.6%	0.8%	13.7%
CAD per USD	-1.8%	12.5%	9.4%

Source: Datastream 10/30/2015

CHART OF THE MONTH



NATIONAL BANK

Fed: December hike or not?

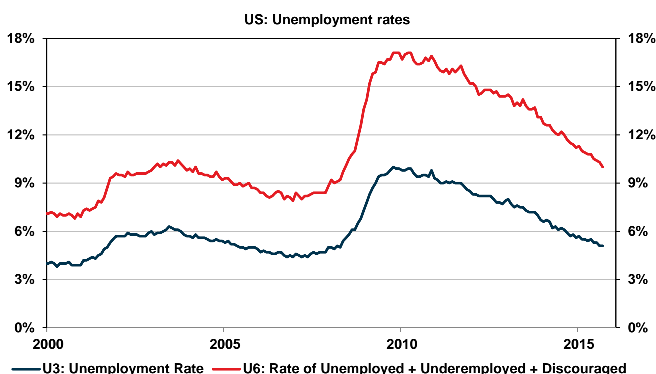
As expected, the U.S. Federal Reserve (the Fed) left the rates unchanged in October, but all eyes were on the statement tied to the announcement. As always, such a document is subjected to parsing and conjecture but the current one was special because it could potentially contain information on the committee's intentions for the next meeting. The Fed certainly understands the consequences of changing a few words and what experts in "Fedspeak" would conclude from such subtle modifications. Here's a key part of the statement that got the most attention:

> *"In determining whether it will be appropriate to raise the target range at its next meeting, the Committee will assess progress -- both realized and expected -- toward its objectives of maximum employment and 2 percent inflation. This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial and international developments."*

Those two words: "next meeting" were a very clever attempt to signal that December was still a very viable option for a liftoff, while limiting the risk of spooking the markets too much. The process remains data dependent and the Fed clearly states what it's looking at to base its decision upon:

- Labor Market conditions: Though the Central Bank acknowledged the slower job growth, it did stress the improved employment situation such as diminished under-utilization (chart 2). The committee will be inclined to hike if the official unemployment rate and the U6 under-employment rate continue their downtrends. Most participants think that job creation numbers close to 140k in the next months would be considered satisfactory for a hike.

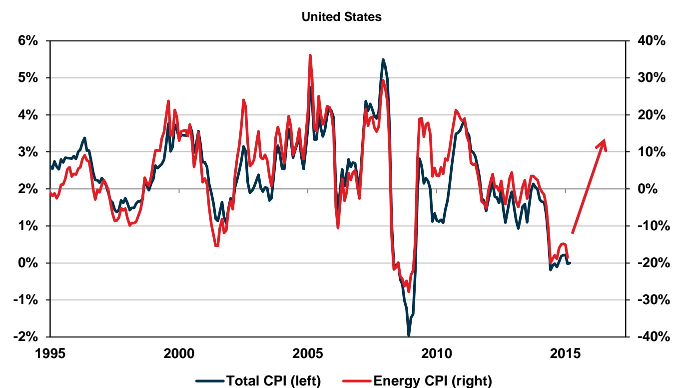
Constantly improving



2 Source: Datastream

- Inflation pressures and inflation expectations: There's a big distinction to be made between "pressures" and "expectations." The "pressure" part of inflation has been running lower than what the committee expects, partly reflecting lower energy and import prices, while the "expectations" part has remained stable. The "pressure" part is transitory and will subside as time goes by, since crude and U.S. dollar levels only need to stay stable to start seeing inflation tick up towards the bank's long-term target (chart 3). Even though crude oil rebounded from its August lows, prices are still down close to 42% on a yearly basis. A "no change" on factors dragging inflation down would be considered enough for tightening.

Only a question of time



3 Source: Datastream

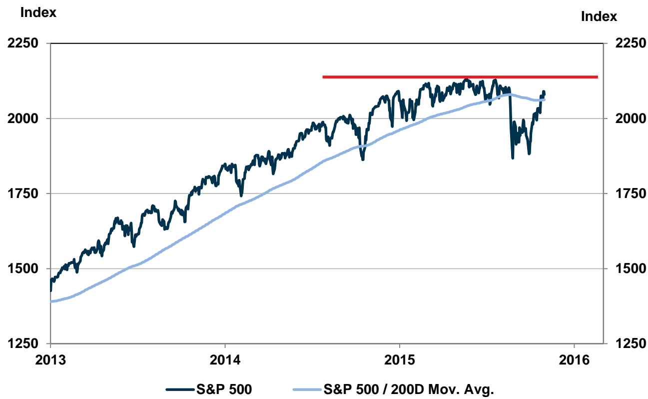
- Financial and international developments: While chair Yellen has expressed some concerns about global risks in September, this month's view of international events are much less salient and the risk of spillover has diminished greatly. While global economic news is on the Fed's radar, it won't prove to be important enough to affect policy in the near future unless the situation deteriorates significantly.

This year has been a continuum of false starts and diverse reasons delaying the inevitable tightening. The soft patch early this year caused by a bad winter was followed by "Grexit" fears in the summer which then transitioned to China's slowing growth and stock market correction in the Fall. Chair Yellen just couldn't get a window open long enough to pull the trigger without adding fuel to the fires that were previously burning. However, the delay did give some opportunity for the Fed to reassess the pace of tightening and help ease the market's reaction to the eventual liftoff. We think December is still in the cards for normalization, barring any unforeseen events… and the pace of tightening will be much more gradual than previous tightening periods, which should reassure investors.

Equities: follow the leader and use history as a guide

The Fed's more hawkish than anticipated tone didn't seem to faze equities much, as the S&P 500 jumped 1.2% the day of the announcement. In fact, October proved to be very good for stocks since fear from the August correction is gradually subsiding. We are now within shooting distance of the highs made in July and it will be interesting to see if they will act as a big resistance level or a jumping point to new heights (chart 4).

Will the July levels act as a resistance or a springboard?

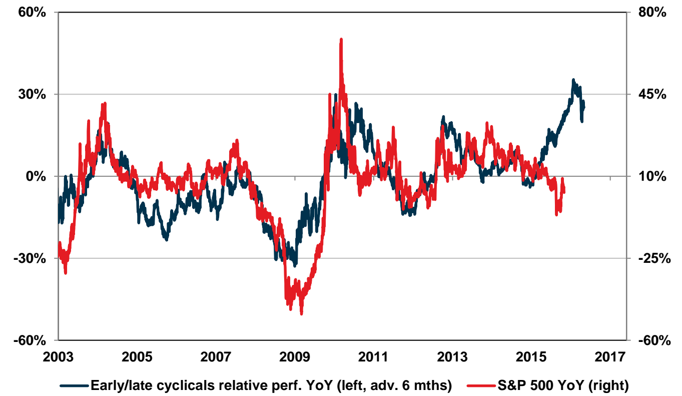


4 Source: Datastream

It certainly feels like we are now at an inflection point since stock market returns seem to have rebounded faster than what would have been justified by current economic indicators. Time will tell if the rebound was justified or not, but there are a number of factors to consider as we head into year-end:

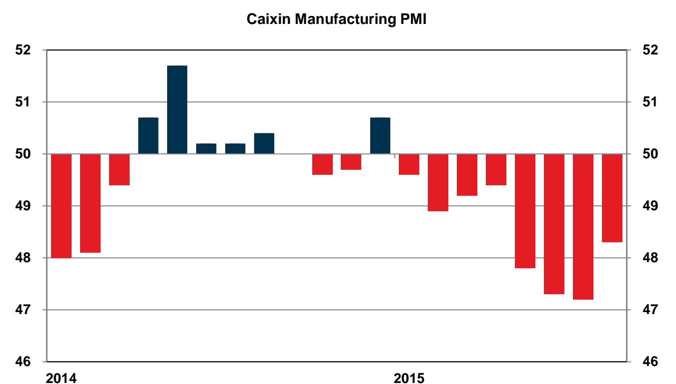
- Early vs. late cyclicals: As we can see in chart 5, the early cyclicals (financial, IT and consumer discretionary sectors) are leading the way with regard to performance and this bodes well for the rest of the index. These sectors certainly benefitted from the low interest rate environment and a clear signal that the U.S. economy bounced back from the soft patch we witnessed at the beginning of winter. As late cyclical stocks are composed of energy, materials and industrials, can we expect a rebound of commodity and industrial production related companies? While the energy sector is still sorting out its overproduction problem, other parts of the commodity complex, like base metals, have certainly suffered from the Chinese slowdown. However, we think the weakening growth has now been "priced-in," which means further weakness in the complex would need to be triggered by more negative surprises.
- China: The Fed statement in September about global risks may have pushed investors to think the situation was worse than it really is. If the Fed is delaying the tightening because of what's happening in China, it must mean that the situation is critical, right? Probably not; we think the central bank was more worried about market volatility than the slowing Chinese growth. A hike at that specific time when fear was gripping the markets would have been ill-advised. While there's no hiding the fact that China faced some economic headwinds (chary 6) and a stock market bubble, government authorities are trying their best to reverse the trend. One of the solutions put forth by the People's Bank of China (PBOC) has been a continuous lowering of its benchmark lending rate and commercial bank reserve requirement ratio. October 23 marked the 6th time the rate was revised down since October 2014. We are now celebrating the one-year anniversary since the first cut, which means the economy should start benefitting from the stimulative effects of policy implemented by the government. Lower mortgage rates have already helped put the real-estate market into healing mode (chart 7, next page), and once the PMI starts improving, stocks will be well positioned to benefit. If

Follow the leader



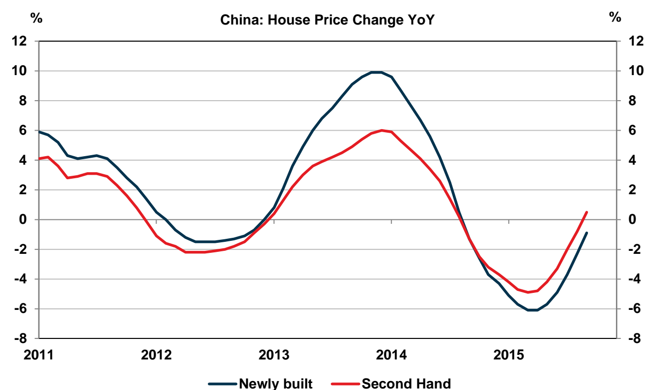
5 Source: Datastream

Will the PBOC policies start to have an effect?



6 Source: Datastream

Housing on the mend



7 Source: Datastream

growth doesn't reach the PBOC's target, the bank still has a lot of tools at its disposal to redress the situation.

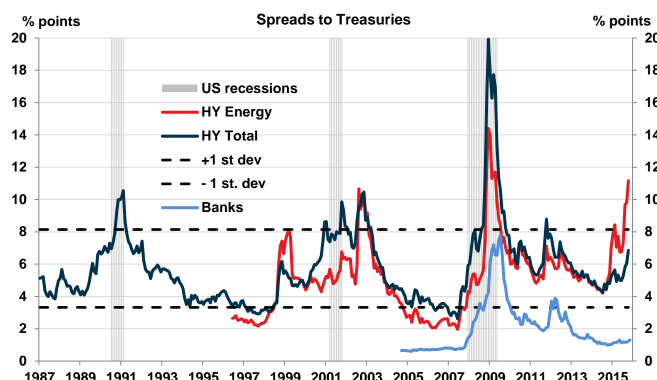
- Asian crisis? With the devaluation of the Yuan in August, some investors were afraid we would be witnessing an Asian crisis 2.0. Both periods may share some similarities but we think "crisis" may be too strong a word for the 2015 version. The Shanghai Index rebound seems to have put some of the August concerns to rest for now. However, we are willing to play along and study history by comparing the market reaction between the two periods (chart of the month). Bear in mind that the 1997-1998 Asian crisis was much worse than what we are witnessing now, so we have good reasons to feel optimistic about the prospects for Chinese stocks if the government can stimulate growth going forward.
- Dovish ECB: While the PBOC is deep into easing mode, the ECB also has a very accommodating stance. Bank President Mario Draghi hinted that more action and further cuts could be on the way. Words are sometimes as powerful as actions when markets need to be reassured, and the dovish tone taken by Mr. Draghi should help boost investor confidence in the ECB's seriousness for action in stimulating growth. The quantitative easing effects started in March should begin bearing fruit soon.

Dissecting the high yield bonds

The August rout and China situation created some collateral damage in the credit markets, especially for high-yield bonds, which are more vulnerable to economic downturns. Those types of bonds handsomely reward any investor willing to take on higher risk. However, high-yield bonds can turn sour very quickly should the situation deteriorate faster than what markets anticipate, since credit events are usually tied to liquidity stress. As such, they have a certain "fear gauge" property to them, and continued upticks in spreads are met with more and more questions about the solvency of the issuers as well as the asset class at large. This fear can quickly turn into panic if concerns undermining the asset class are founded.

Since spikes in credit spreads tend to coincide with a recession or major market turmoil, the recent increase certainly warrants vigilance. However, the problem is mainly localized in the energy sector, which represents roughly 15% of the index, and should not be perceived as an indicator of the overall state of the credit markets (chart 8). If banks' credit spreads started to show signs of stress we would start worrying, but for now the risk of contagion seems relatively low. As the Chinese situation improves, we expect the spreads to begin to narrow. As such, we think high-yield bonds represent a good investment opportunity at current levels.

No reason to panic



8 Source: Datastream

Asset allocation

We believe the deceleration of growth in China 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, since they are more exposed to the slowdown and a strong U.S. dollar. As such, for equities we would prefer to tilt our allocation toward developed markets and away from emerging markets.

While U.S. equity valuations may seem less attractive in than their counterparts, we think they are benefiting from a premium attached to the safe-haven status of the U.S. and its relatively stronger economy. We also advise keeping Canadian equity exposure neutral/underweight, since energy products have still not emerged from their overproduction cycle. The greenback has had a great run but we think a very gradual hedging back to Canadian dollar-denominated assets is advisable.

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 rising to 3% as a buying opportunity.

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				X			X			
Bonds		X					X			
(Duration)			X				X			
Federal		X				X				
Investment grade			X				X			
High yield (USD)				X					X	
Non-traditional income				X					X	
World equities				X					X	
S&P/TSX			X					X		
S&P 500 (USD)				X					X	
Growth vs Value			X					X		
Large cap. vs Small cap.		X							X	
Defensives vs Cyclicals		X					X			
MSCI EAFE (USD)				X					X	
MSCI EM (USD)		X					X			
Alternative investments			X					X		
Commodities			X					X		
Energy				X					X	
Base metals				X					X	
Gold			X				X			
Hedge funds (USD)			X					X		
REITS		X					X			

Source: Consulting Investment Committee

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