



INVESTING

Asset Allocation Strategy

Looking forward to a hike?

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Market review

Not all months can be up like this past October. Most indices seemed to lack direction in November while assessing how to react to an increasing possibility of a Fed rate hike in December. According to the futures market, the chance of a hike rose sharply, now standing at 74%. The U.S. dollar also reacted to these improved odds by increasing by 3.3% to close out the month at a 12-year high.

On the fixed income side, yields reached on the U.S. 2-year notes increased to levels unseen since 2010 as they closed out the month at 0.93% (+0.2%) while their 10-year counterparts started strong but weakened gradually to finally close at 2.22% (+0.07%).

Asset allocation strategy

- With important international source of risks now in check, only domestic issues could prevent Fed chair Janet Yellen from fulfilling her promise to raise rates before the end of the year.
- In theory, monetary policy tightening would be considered detrimental to stocks. This is not always the case. Though all periods following the initial hike witnessed some choppiness in the first six months, the following semester performed much better.
- In light of the recent U.S. dollar performance and the current market positioning, we think it's time to take some profits and gradually increase our currency hedge.
- Even if we think the Fed's tightening will have a minimal impact on U.S. stock returns, we believe their European counterparts may offer better prospects on a relative basis.
- On the bond side, we expect yields to react to the tone set by the Fed after the initial tightening via increased volatility on a short-term basis.

Table 1 Market total returns

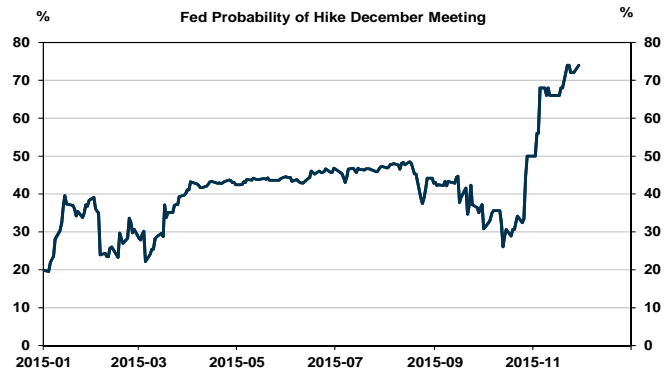
Asset classes	November	YTD	12 months
Cash (3-month T-bills)	0.0%	0.6%	0.7%
Bonds (FTSE/TMX Univ.)	0.1%	2.4%	2.9%
FTSE/TMX Federal	0.0%	2.6%	3.1%
FTSE/TMX Corporate	0.4%	2.1%	2.4%
FTSE/TMX BBB	0.6%	2.1%	2.5%
BoAML High-Yield (USD)	-2.2%	-2.1%	-3.5%
World equity MSCI (USD)	-0.8%	-0.1%	-2.0%
S&P/TSX	-0.2%	-5.4%	-5.8%
S&P/TSX Small cap	-1.7%	-11.9%	-12.2%
S&P500 (USD)	0.3%	3.0%	2.7%
Russell 2000 (USD)	3.1%	-0.5%	2.1%
MSCI EAFE (USD)	-1.5%	0.9%	-2.5%
MSCI EM (USD)	-3.9%	-12.7%	-16.7%
Commodities (CRB index)	-2.8%	-12.3%	-15.5%
WTI oil (US\$/barrel)	-10.3%	-22.7%	-37.1%
Gold (US\$/ounce)	-6.8%	-10.3%	-10.0%
Copper (US\$/tonne)	-10.3%	-27.8%	-28.3%
Forex (DXY - US Dollar index)	3.3%	11.0%	13.4%
USD per EUR	-4.4%	-12.7%	-15.3%
JPY per USD	2.1%	2.8%	3.8%
CAD per USD	2.2%	15.0%	17.1%

Source: Datastream

11/30/2015

CHART OF THE MONTH

The market has spoken, and it's a hike!



1 Source: Datastream



Rate hike: the table is set

While many will argue that the underlying environment is still sub-optimal for justifying monetary tightening as total inflation remains stubbornly low, manufacturing is struggling, and there are some concerns about the state of the global economy, (particularly in Asia), it is difficult to say that things haven't improved recently. Abroad, the Chinese stock market is now some 20% above its August trough, suggesting recent easing measures are slowly starting to overcome investors' fear of a hard landing (chart 2).

Chinese stock market back on track



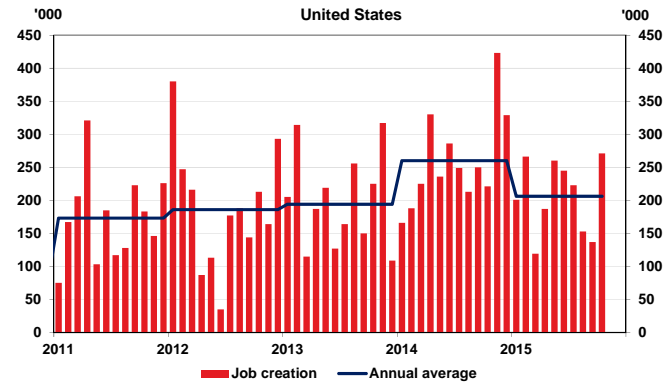
2 Source: Datastream



With this important source of risk now in check, only domestic issues could prevent Fed chair Janet Yellen from fulfilling her promise to raise rates before the end of the year. To that effect, things look solid enough. Although the manufacturing sector has been suffering (partly due to the weaker exports caused by a strong U.S. dollar), the second estimate for Q3 real GDP numbers came out at 2.1%, an upward revision of 0.6% from the previous estimation, and consumption has been a solid and constant contributor to the overall U.S. economic performance of the last year. And, this looks set to continue in Q4 as ISM services, although softer in November, remains firmly in accelerating territory. Consumer confidence is also strong as it remains at its highest level since 2007 while the upward momentum in labour continues with non-farm payrolls registering a consensus, topping a 271,000 increase in employment for October - the best month of 2015 (chart 3).

True, although the job market remains red-hot with the unemployment rate closing in on 5%, wage increases are only showing moderate improvement. However, we think this will not be a factor in the Fed's decision process as that aspect is only one piece of the overall inflation puzzle. As services inflation has been constantly inching up, highlighting how strong that sector of the U.S economy has been lately, energy

Labor market momentum strong enough

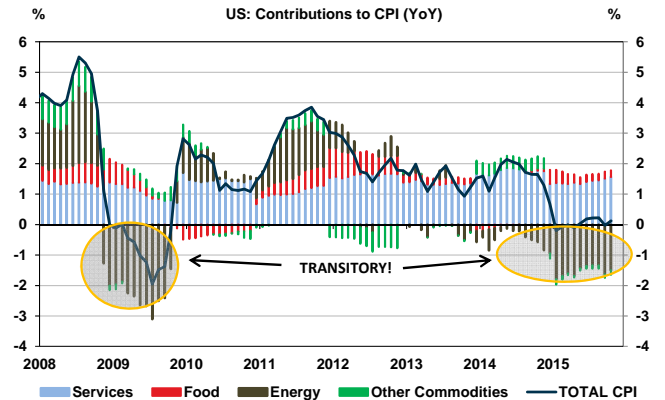


3 Source: Datastream



prices remain the main culprit weighing on the consumer price index (CPI) this year. But the financial crisis of 2008 is a good reminder as to how inflation reacts to a sharp decline in crude prices, and the reversal of the impact on overall figures has the potential to be brutal (chart 4).

Inflation details



4 Source: Datastream



There's also a political side to consider as chair Yellen seems committed to a hike this year and credibility is as important as action in implementing monetary policy. Reneging on this engagement would be badly received by investors. Market expectations suggest the Fed will tighten its monetary policy for the first time in nine years at the next FOMC meeting in December (chart of the month) barring any major economic event disrupting growth.

Rate hike: what are the consequences?

Predicting how markets will behave following a rate hike is a daunting proposition. However, studying what happened in the past three monetary tightening phases (1994, 1999 and 2004) can be a useful exercise. For a sound analysis, it's important to understand the underlying environment for each period:

- In 1994 - the economy was emerging from a big recession partly caused by the savings and loan crisis. The economy was adding an average of 275,000 jobs per month and unemployment was at a 4-year low. Corporate profits and disposable income were rapidly rising.
- In 1999 - the peak of the tech bubble, the aftermath of the LTCM fiasco, and the Russian financial crisis. The unemployment rate drifted down to 4.1%, its lowest level since the early 70s.
- In 2004 - markets were rebounding from the fallout of the Enron and WorldCom scandals, U.S. growth was solid, and the country was running huge budget deficits partly due to tax-cut measures. Oil prices jumped 50% from January 2002 to June 2004.

There's a saying "history doesn't repeat itself, but it does rhyme" and there are some similarities to draw between the three previous hikes and the current environment:

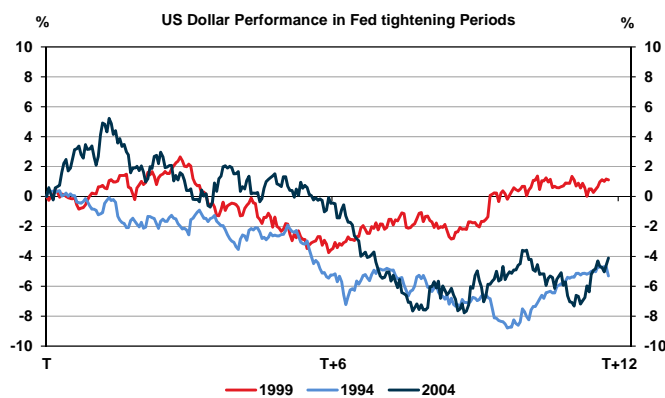
1. The desire by the Fed to pre-emptively strike against potential rising inflation though there were no clear trends about overheating on that front.
2. The Improving macroeconomic environment, usually witnessed by a very strong labour market reflected by declining unemployment rates and solid non-farm payroll numbers.
3. Decent GDP growth in the quarters preceding the first hike.

Impact on U.S. dollar (chart 5):

The results are not what one would usually expect from a currency benefitting from a hike. The 2004 and 1994 periods saw an average decline of 5% in the DXY one year after the initial hike, while 1999 was up only 1.5%. This indicates that markets are usually well aware of the Fed's intentions and their risk allocation is already positioned for the move.

The current period seems to be no exception (chart 6) as speculators still have a sizeable long position in the U.S. dollar. Although the long exposure is not as extreme as what we witnessed earlier this year, it's still high by historical norms suggesting that the currency is overbought and there's limited upside for the DXY for now.

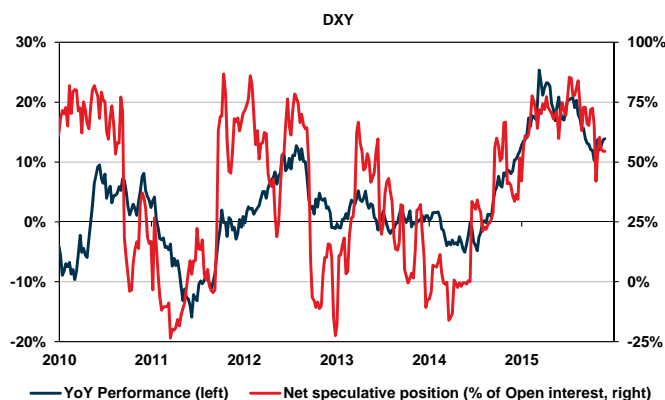
USD not really benefiting from a hike



5 Source: Datastream



Speculators have been anticipating the hike for a while



6 Source: Datastream

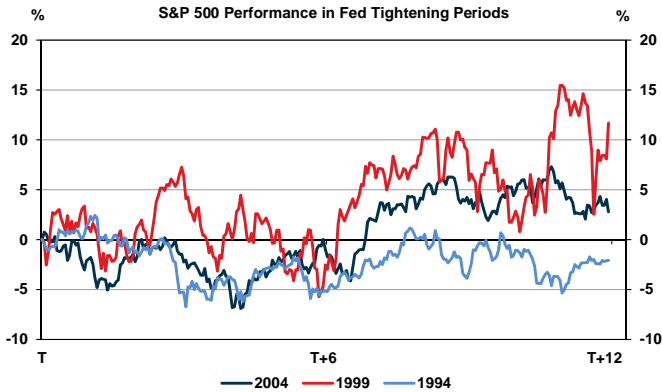


While we are aware that the Fed is the first central bank considering tightening, at a time when while others are still pushing accommodative policy, we think this is a typical "buy the rumour, sell the news" type of environment.

Impact on S&P 500 (chart 7, next page):

In theory, monetary policy tightening would be considered detrimental to stocks. The whole focus on the timing of the hike is a direct consequence of that assumption, as investors are afraid of the adverse effects increased borrowing costs will have on earnings prospects. As chart 7 shows, this is not always the case. Though all periods witnessed some choppiness in the first six months after the first hike, the following semester performed much better. Only in 1994 is the stock market performance underwhelming and we think this is a consequence of the surprise effect of the hike at that time. The Fed learned its lesson after that episode and became much more transparent in communicating its policy.

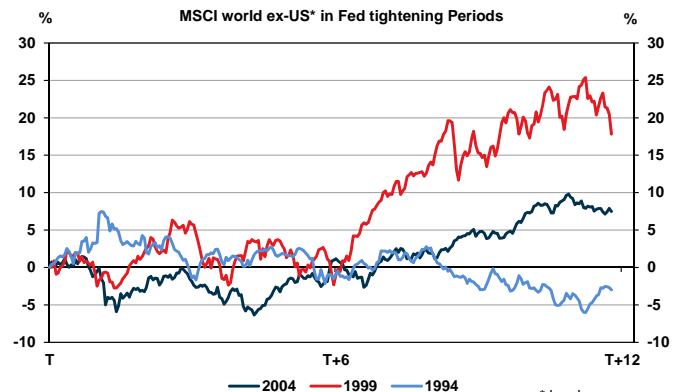
Transparent Fed = good performance



7 Source: Datastream



No Impact on Global Equities



8 Source: Datastream

* local currency



One aspect to consider while assessing past performance is the macro environment that prompted the Fed to act. Employment was strong, which spurred up consumption and helped bolster company earnings. As such, it would be safe to assume that the overall state of the economy has had more influence on stock performance than borrowing costs.

We think the current period will not differ materially from the 1999 and 2004 scenarios. The Fed has been very transparent in its approach and investors have been well prepared for a rate hike. Though markets may go sideways or witness increased volatility in the weeks or months following the meeting (partly due to uncertainty about the future path of hikes), we think that the state of the U.S. economy will take center stage and help push equities higher.

Impact on Global Equities (chart 8):

The only term we can use for Global Market equities ex-U.S.A. with regard to a rate hike is: undeterred. Foreign countries certainly benefit from a strong U.S. economy via exportations, and their respective central banks can adjust their monetary policy to maximize those benefits. As we see in table 2, most countries were also showing strong growth in tandem with the U.S. Basically, the conclusion for global equities is the same as for the S&P500: when it comes to earnings and equity returns, the state of the economy trumps borrowing costs or monetary policy.

As for the current situation in Europe, the region is negatively affected by weaker exports caused by the slowdown in Asia. However, Mr. Draghi's QE, which started nine months ago, is beginning to have an effect on domestic consumption. Further easing measures put in place by the ECB to stimulate low inflation should help European equities perform in the future.

Table 2: Real GDP (% annual change)

Country	1994	1999	2004
World	3.7%	3.6%	5.1%
Advanced economies	3.4%	3.4%	3.2%
US	4.0%	4.1%	3.9%
Canada	4.7%	5.1%	3.3%
EU	2.8%	2.7%	2.1%

source: IMF

As for emerging markets, while commodity importing countries are faring better than their producing counterparts, overall the sector is experiencing a slowdown, partly due to weakening growth in China. Many investors are also worried about increasing corporate debt since 2007. However, as the U.S. dollar stabilizes and China shows more improvement, we think the sector could become a buying opportunity.

In Conclusion:

The goal of this exercise is to show how little impact the initial hike has had on market performance, especially when the Fed is transparent in its approach so that investors can plan ahead to position themselves accordingly.

As of right now, we think the major risk lies in the disagreement between dovish market expectations and FOMC members' more hawkish views regarding the pace of future hikes. This point of contention could have an adverse effect on future return prospects should the Fed persist in its projected course of action. We expect the central bank will strive to ease the effect of the first rate increase with a very accommodating tone in its December statement and generate a "dot plot" that converges a little bit toward a slower pace of hikes.

Asset Allocation

In light of the recent U.S. dollar performance and the current market positioning, we think it's time to take some profits and gradually increase our currency hedge.

Even if we think the Fed's tightening will have a minimal impact on U.S. stock returns, we believe their European counterparts may offer better prospects on a relative basis, as the ECB is still pushing accommodative policies which should generate better earnings prospects for equities. As China's biggest trade partner, the region is also better suited to take advantage the country's eventual rebound.

On the bond side, we expect yields to react to the tone set by the Fed after the initial tightening via increased volatility on a short-term basis. As such, 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.

Municipal bonds also look particularly attractive as the yield is around 1% above provincial yields.

Preferred shares got beaten up a lot this year, and that makes the asset class vulnerable to further selling due to tax-loss incentives heading into year-end. However, we think they hold greater value than high-yield bonds at a much lower risk on a tax-adjusted basis.

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

Source: Consulting Investment Committee

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