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INVESTING

Asset Allocation Strategy

January blues

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Highlights

The year started with a bang, but it wasn't in the direction anyone wished as China fears, added to the downturn in crude prices (-9.4%) created a general malaise that set up a major bout of risk-asset sales across the globe. A last minute rally wasn't enough to offset the worst January performance since 2009 for the S&P 500 (-5.0%). Its Canadian counterpart didn't fare any better, recording its third negative month in a row which is a consequence of crude oil troubles and mounting economic challenges in the country.

On the bond and currency side, the diminishing probabilities the Fed will hike rates in March and beyond impacted U.S. 10-year treasury yields as they lost 35 bps to close the month out at 1.93%. As for the US dollar, the risk-off mindset triggered a flight to quality asset movement that helped the currency appreciate 1.0%. The loonie dropped to 0.68 US$ before rebounding at the end of the month.

Asset allocation strategy

- We think markets are currently over-emphasizing bearish indicators and short-term news while ignoring the rest of the global environment. As such, there now seems to be a growing disconnect between dramatic financial market moves and the underlying economic situation.
- The current energy levels are the result of an overall oil glut, not decreasing consumption.
- While we believe defaults in the oil sector will ramp up in the coming months, this has been largely discounted in the markets via increasing spreads.
- Unless the situation improves materially in the near future, March is now out of the question for a hike and markets are now pricing fewer than two hikes in 2016.

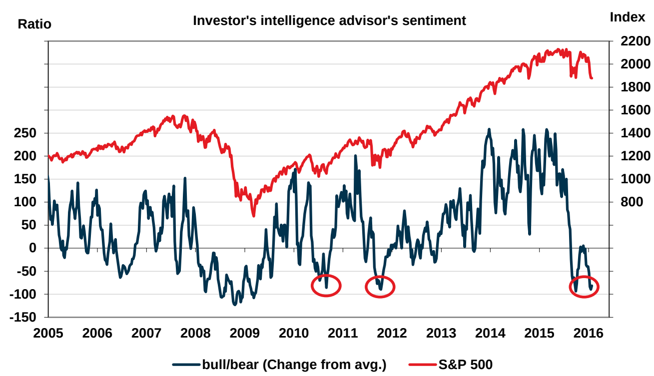
Table 1 Market total returns

Asset classes	January	2015	2014
Cash (3-month T-bills)	0.1%	0.6%	0.9%
Bonds (Dex Overall Universe)	**0.4%**	**3.5%**	**8.8%**
FTSE/TMX Federal	0.9%	3.7%	6.9%
FTSE/TMX Corporate	0.0%	2.7%	7.6%
FTSE/TMX BBB	-0.1%	2.5%	9.0%
BoAML High-Yield (USD)	-1.6%	-4.6%	2.5%
World equity MSCI (USD)	**-6.0%**	**-1.8%**	**4.7%**
S&P/TSX	-1.2%	-8.3%	10.6%
S&P/TSX Small cap	-4.1%	-13.3%	-2.3%
S&P500 (USD)	-5.0%	1.4%	13.7%
Russell 2000 (USD)	-8.8%	-5.7%	3.5%
MSCI EAFE (USD)	-7.2%	-0.4%	-4.5%
MSCI EM (USD)	-6.5%	-14.6%	-1.8%
Commodities (CRB index)	**2.3%**	**-14.4%**	**-4.1%**
WTI oil (US$/barrel)	-9.4%	-30.9%	-45.4%
Gold (US$/ounce)	5.2%	-10.4%	-1.8%
Copper (US$/tonne)	-2.9%	-26.1%	-13.7%
Forex (DXY - US Dollar index)	**1.0%**	**9.3%**	**12.8%**
USD per EUR	-0.4%	-10.2%	-12.2%
JPY per USD	0.6%	0.5%	13.7%
CAD per USD	1.0%	19.1%	9.4%

Source: Datastream 1/29/2016

CHART OF THE MONTH

Is the current pessimism really justified?



Source: Datastream

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NATIONAL BANK

Three factors causing a crisis of confidence

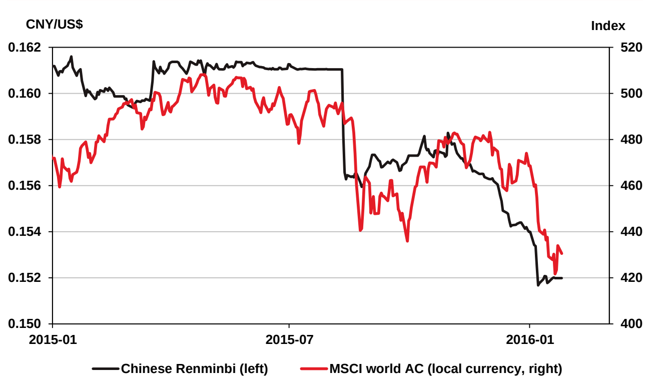
> *"Wall Street indexes predicted nine out of the last five recessions! And its mistakes were beauties."*
>
> *-Paul A. Samuelson*

January brought everything except new beginnings, as old problems came back with a vengeance. The bad performances and increased volatility that put most investors on the defensive seem to have been triggered by three sources of concern constantly making the headlines: questions about China's growth and potential sharp devaluation of the Yuan, the energy market's rout, and increasing credit contagion fears. These factors are all connected to some extent and represent legitimate questions about global growth prospects.

However, we think markets are currently over-emphasizing bearish indicators and short-term news while ignoring the rest of the global environment. As such, there now seems to be a growing disconnect between dramatic financial market moves and the underlying economic situation (chart of the month). While this perception vs. reality problem may persist longer, separating the real sources of risk from the noise will help determine good opportunities once it's time to play offence.

- **China's stock market drop and Yuan depreciation:** History doesn't repeat itself, but it does rhyme, and it does feel like we're back in August 2015, doesn't it? Investors are still wary of the weakening Chinese currency and what it means for the country's general economic health. Recently, stock markets have shown an extreme sensitivity to the Yuan (chart 2). A drop of 3.75% in the currency's value generated a 13% loss for the MSCI AC World Index -- a clear over-reaction.

Overreaction?



Source: Datastream
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Looking at the headlines, the optics are bad, growth is slowing down, and there's lingering doubt that the authorities might have to drastically devalue the CNY. This could be interpreted as a complete 180-degree turn back to the old model of unsustainable growth and would further unsettle other emerging markets (which are much more vulnerable to competitive devaluation). A sudden Yuan movement would also complicate the Fed's plan as lower prices from Chinese producers would create additional deflationary pressures in the U.S.

Although the probabilities of such an occurrence are non-negligible, we still believe we won't get to that point… yet. While Chinese authorities are denying any plan to instigate a bout of "currency wars," the jury is out on whether we should believe them. The fact that the PBOC seems to have transparency/communication issues regarding its monetary policy certainly doesn't help in that matter.

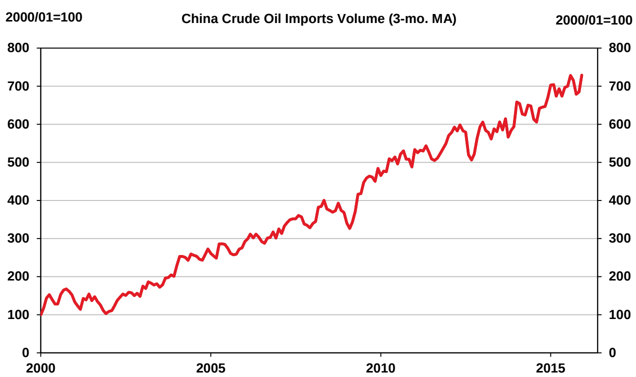
However, China is still gaining market share in world exports and a sharp devaluation would be hard to justify in the global community, especially at a time when the government wants the nation to be recognized as an important player in world affairs.

Unless the situation deteriorates materially from this point on, the PBOC will probably take a middle ground approach by implementing policies that would generate a soft landing toward a foreign exchange rate they feel comfortable with while maintaining the transition of its economy. This strategy would have the benefit of limiting sharp domestic and international capital outflows while diminishing the potential for further market turmoil.

As for Chinese stocks, we think they are suffering from the current "risk-off" mood currently dogging the markets. Moreover, such performances become a vicious cycle. As prices drop, investors get more risk-averse and question the nation's economic health which, in turn, triggers more sales. If we exclude the psychological factor, the impact from the downturn remains fairly small, as equities only represent a tiny fraction of household assets in the country.

- **Crude oil's price decline:** The other event used as an example that China and global growth are slowing down is the current crude oil price decline. While we agree that lower economic activity is certainly influencing overall commodities demand, the energy levels are the result of an overall oil glut, not decreasing consumption. In fact, the mainland's imports of energy products have maintained the pace set in 2004 (chart 3). As for the rest of the world, demand growth has also remained fairly constant (chart 4). We think using crude oil as a proxy for growth is ill-advised because, for the moment, the price-setting mechanism is more dependent on supply dynamics than economic conditions.

China's crude consumption is undeterred



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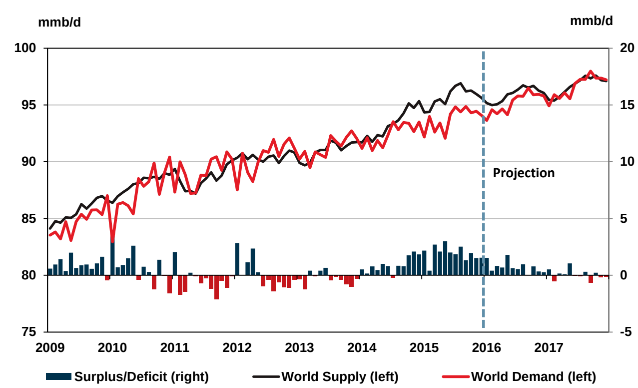
World demand has increased constantly



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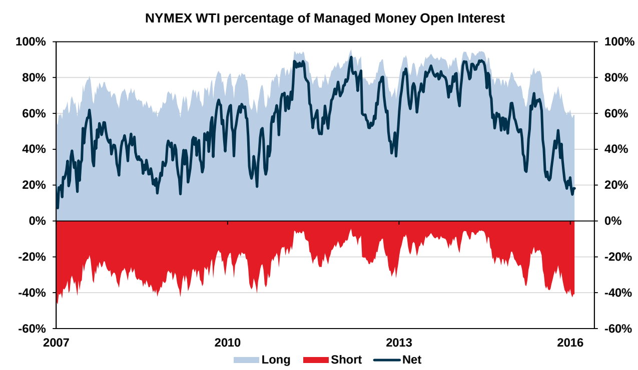
In January's letter, we argued that higher levels in Q2-2015 postponed the rebalancing pressures because producers could, once again, lock in fairly attractive margins. However, the reverse is also true, and last month's downturn may well be the push needed to influence production curtailments and shorten the path to recovery. The production figures in the following months will confirm if that's the case. Until then, the scenario for a rebalancing of the supply-and-demand picture in the second half of 2016 is still valid.

The recent developments have also increased the amount of speculative money in the universe and positions have reached a point where there's now a higher probability of a "short squeeze" which usually results in short and violent spikes in prices (chart 5). These are typically temporary in nature and have a tendency to reverse quickly, so a confirmation of the floor will have to wait until fundamentals clear up for good.

- **Energy credit risk contagion fears**

Markets are very short, a rebound on the horizon?



Source: Datastream

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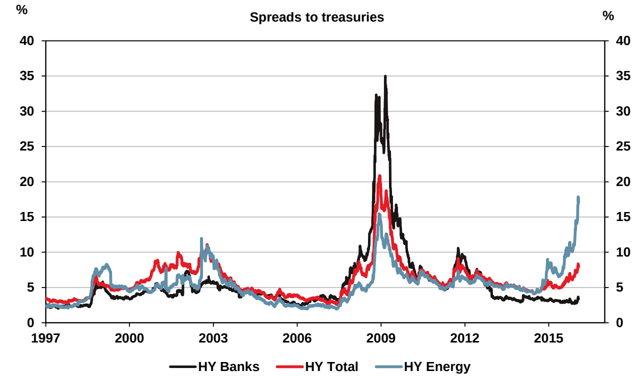
As energy prices drop lower and lower and company margins follow suit, fears about increasing probabilities of a credit event intensifies, especially in the high-yield bonds space. While we believe defaults in the oil sector will ramp up in the coming months, this has been largely discounted in the markets via increasing spreads.

The impact should remain fairly constrained as energy-related companies only represent 10% in the asset class and energy producers represent an even smaller share at 5%. The banking high-yield spread is probably the best early indicator of stress in the space and, as long as they remain healthy, there's no cause for concern (chart 6, next page).

Risk managers and lawmakers have a tendency to fight the last war and, since the financial crisis, a lot of measures have been introduced to mitigate the potential of another one. Banks are now much more capitalized, aware of underlying risks, and much more aggressive in containing them.

No signs of contagion to the banking sector



Source: Datastream
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So, where do we go from here?

It does look like 2016's theme will be short-term pain for long-term gain. Usually, when a sharp downturn occurs or a risk-off mindset is well entrenched, investors have a tendency to sell everything indiscriminately with no regard for valuations or fundamentals. Markets are forward looking which means new information will need to show further deterioration from what we witnessed recently in order to justify additional selling. This situation usually presents good buying opportunities, but only when the dust settles and cooler heads prevail.

Though promising, the rebound witnessed at the end of the month will need some catalyst to continue and generate more positive momentum before we feel more confident that a floor has been reached. The VIX reverting back under 20% and maintaining a lower level for a couple of weeks would be such an occurrence as it will be a sign that most of the fear witnessed in the last couple of weeks has faded.

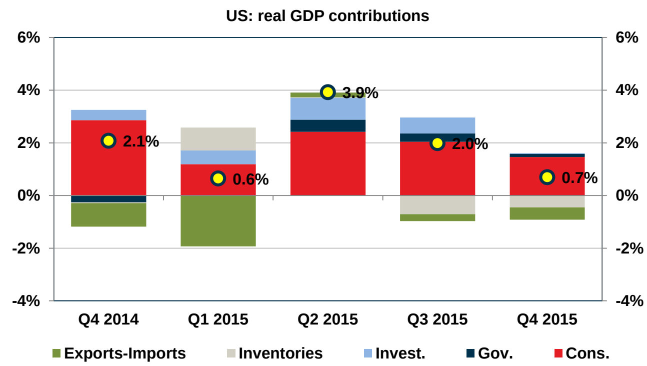
The current mood set the bar very low so markets are now "priced to imperfection," which means the probabilities of a positive surprise are now much higher. As such, strong performances resulting from solid economic numbers or central bank stimulus would also constitute a good signal.

In a fast moving market, it's easy to lose focus and forget about the big picture. Notwithstanding the bad news of late, China is still expected to grow around 6.3% in 2016 while the U.S. should post close to 2% -- hardly a recessionary environment.

Fed: data dependence includes global developments

The deterioration of global economic conditions pose risks to the U.S. growth and the Fed acknowledged as much in the statement following its rate decision of December 27. This should serve as a calming effect for investors worried that the central bank is only considering domestic data in its policy decision process. Global pressures aside, the chair Yellen probably noticed the U.S. also had its fair share of bad news last month as the U.S. Q4-GDP decelerated to just 0.7% (annualized), hardly a good send-off to 2016 (chart 7). Not surprisingly, the strong U.S. dollar and challenges abroad created major headwinds for manufacturing domestically.

Trade and inventories are dragging GDP numbers down



Source: Datastream
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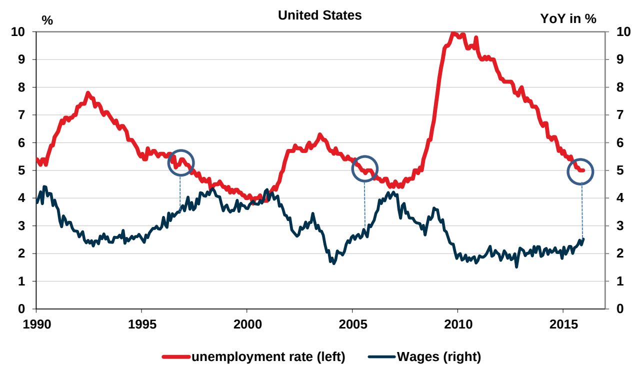
However, there are some bright lights still pushing growth forward. The services sector is still in expansion mode and, although wage inflation is still tame, employment is constantly improving (chart 8, next page). The real estate market, usually a good leading indicator of consumer confidence (chart 9, next page), is also very healthy; the Case-Shiller Index reported that home prices increased 5.8% year-over-year, while new-home sales rose by a massive 10.8% in December and are now at post-recession highs.

It seems 2016 will be an echo of 2015 for the U.S. economy. The Fed certainly hopes the transitionary effects from crude oil prices and U.S. dollar strength eventually subside, but we've heard that song before. For now, the bank is taking a wait-and-see approach and the path of tightening (chart 10, next page) is softening day-by-day. Unless the situation improves materially in the near future, March is now out of the question for a hike and markets are now pricing fewer than two hikes in 2016. This should counter some of the upside pressure on the U.S. dollar caused by foreign central bank easing and eventually give some breathing room to domestic manufacturing and U.S. corporate earnings.

Wage inflation obstinately sticking under 3%



Source: Datastream
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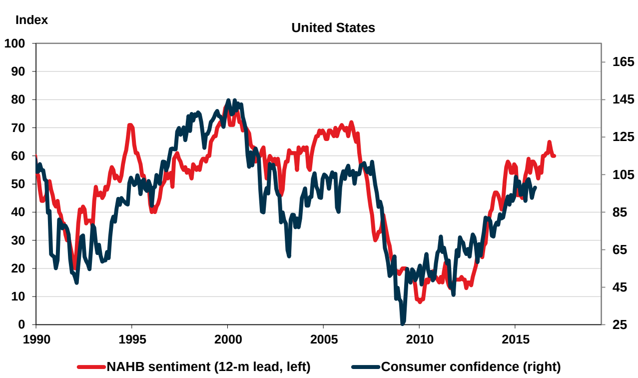
Asset Allocation

The recent downturn sent investors into a more risk-averse mode, however we still don't believe a recession is in the cards in the U.S. We think stocks will outperform bonds in the medium to long term. Markets are still volatile, so over extending risk may not be an appropriate course of action, but slowly picking bottoms (to increase exposure as markets stabilize) may be the best course of action.

Although 2016 still looks challenging for U.S. equities, most valuations are now much more within historical norms (chart 11). We therefore think U.S. stocks will benefit from either a more dovish Fed than initially anticipated or positive economic news. However, European equities should offer even better prospects as they will benefit from a much more accommodative policy from the ECB.

Consumer confidence is closing-in on pre-crisis levels



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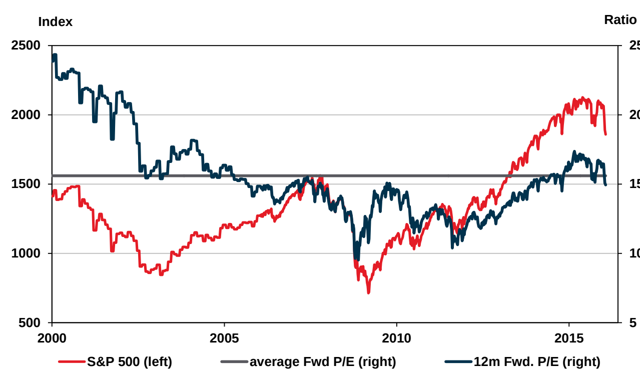
Forward P/E ratio is now much more reasonable



Source: Datastream
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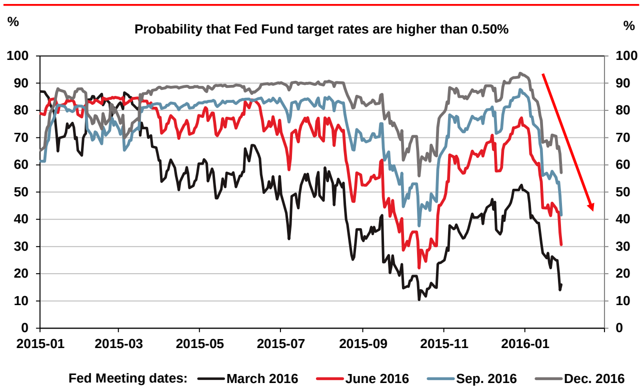
For the Canadian equities, markets remain volatile and we think risks are still not worth the rewards at the moment. Waiting until energy downside risks subside in the second half of 2016 might prove to be the best course of action. The Canadian dollar is still dependent on crude oil's performance and the BoC's monetary policy. With current levels under 70 cents US, we think the major part of the move is behind us and investors should start hedging their currency exposure.

In fixed income, as the market is in flux and there's more uncertainty about the Fed's next move, we think being neutral (both duration- and credit-wise) is the best course of action until we get a clearer picture.

Markets expect a very accommodating Fed



Source: Datastream
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Table 2 Global Asset Allocation (Tactical vs Strategic)

	3-month horizon					12 to 18-month horizon				
	Weight					Weight				
Asset classes	Min	Under	Equal	Over	Max	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