March 2, 2016

# Asset Allocation Strategy

## Spring Cleaning

**MARTIN LEFEBVRE**
CIO and Strategist
(514) 412-8572
martin.lefebvre@nbc.ca

**SIMON-CARL DUNBERRY**
Senior Analyst
(514) 412-8384
simon-carl.dunberry@nbc.ca

### Highlights

The best expression we could find for the S&P 500 in February was: "sharply unchanged," since a rally during the second half of the month wasn't enough to make up for the bad start - its third negative posting in a row. Bolstered by gold, the materials sector (+17.9%) pushed the S&P/TSX into green territory, marking the first positive performance since October 2015.

On the fixed-income and currency side, the soft economic numbers in the U.S. pushed the 10-year bond yields down to 1.74% (down 0.2% in February) while Canadian counterparts stayed virtually unchanged at 1.2%. The loonie followed through the trend set in mid-January and strengthened by 4.3 cents for the month.

### Asset allocation strategy

- We are close to a gradual improvement in the supply/demand balance in the oil space, which should put a floor on prices and stabilize earnings expectations for energy companies that have already been revised downward significantly from the 2015 year-end.
- In the US, we shouldn't expect any change for the Fed's March meeting. The main factor to watch will be the "dot plot," that will tell us much more about the FOMC's intentions, as well as its reading of the current economic situation.
- We think the Canadian stock market is poised to take advantage of the eventual strengthening in energy prices and we would favor the S&P/TSX over its U.S. counterpart.
- The story is the same for the Canadian dollar. We believe hedging the exposure at the current levels against the U.S. dollar will prove wise for investors who have a medium- to long-term horizon, as the currency pairing is tied to crude oil's performances.

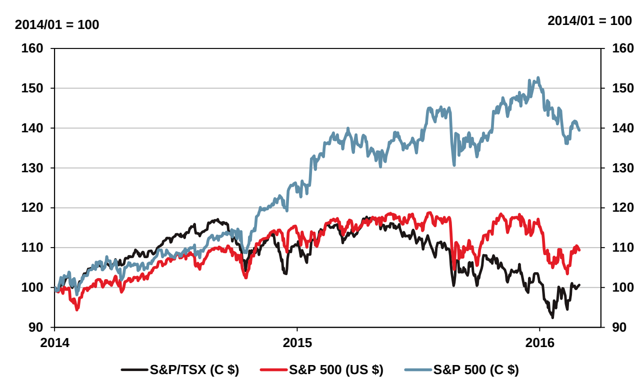
**Table 1 Market total returns**

| Asset classes | February | YTD | 2015 |
|---|---|---|---|
| **Cash (3-month T-bills )** | 0.0% | 0.1% | 0.6% |
| **Bonds (Dex Overall Universe)** | **0.2%** | **0.6%** | **3.5%** |
| FTSE/TMX Federal | 0.2% | 1.1% | 3.7% |
| FTSE/TMX Corporate | -0.1% | -0.1% | 2.7% |
| FTSE/TMX BBB | -0.3% | -0.4% | 2.5% |
| BoAML High-Yield (USD) | 0.5% | -1.1% | -4.6% |
| **World equity MSCI (USD)** | **-0.6%** | **-6.6%** | **-1.8%** |
| S&P/TSX | 0.5% | -0.7% | -8.3% |
| S&P/TSX Small cap | 5.3% | 1.0% | -13.3% |
| S&P500 (USD) | -0.1% | -5.1% | 1.4% |
| Russell 2000 (USD) | -0.1% | -9.0% | -5.7% |
| MSCI EAFE (USD) | -1.8% | -8.9% | -0.4% |
| MSCI EM (USD) | -0.2% | -6.6% | -14.6% |
| **Commodities (CRB index)** | **0.0%** | **2.4%** | **-14.4%** |
| WTI oil (US$/barrel) | 0.3% | -9.2% | -30.9% |
| Gold (US$/ounce) | 10.4% | 16.0% | -10.4% |
| Copper (US$/tonne) | 3.0% | 0.0% | -26.1% |
| **Forex (DXY - US Dollar index)** | **-1.4%** | **-0.4%** | **9.3%** |
| USD per EUR | 0.4% | 0.0% | -10.2% |
| JPY per USD | -6.9% | -6.3% | 0.5% |
| CAD per USD | -3.1% | -2.2% | 19.1% |

Source: Datastream 2/29/2016

**CHART OF THE MONTH**

**Is it S&P/TSX's time to overperform?**




Source: Datastream

## Crude oil: Light at the end of the tunnel

Taken at face value, the mid-February OPEC-Russia agreement to cap crude oil production at January levels can be interpreted as meaningless. As well, Iran is expected to ramp-up its output to pre-sanction levels which weakens the impact from the agreement even more. Although the freeze will not sway markets on a short-term horizon, there are some interesting bits of information investors can take away that could play a more important role in the future:

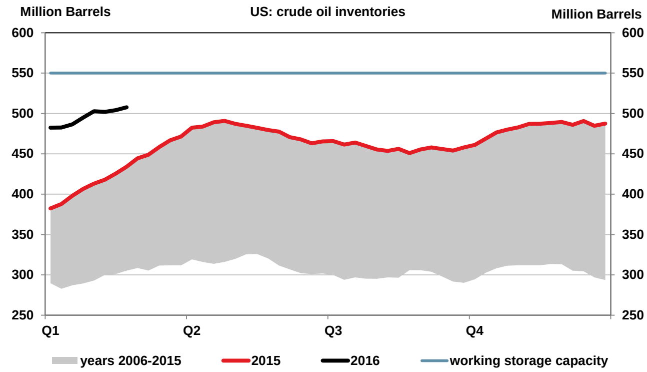
1- Major exporting countries are now feeling the fiscal pain from lower prices and that, as a consequence, a gesture towards price-stabilization is warranted, even if it's symbolic. The fact that Saudi Arabia and Russia came to an agreement is telling, given they are considered geo-political rivals in backing opposing sides on the Syrian civil war.
2- To save the cartel from unravelling even further, the agreement can be considered an appeasing gesture by the Saudis towards the smaller members of the organization, who are in even more precarious positions. As long as OPEC members maintain a certain level of cooperation, the long-term potential for price stabilization from the cartel will remain relevant once the market becomes re-balanced.
3- Russia, Saudi Arabia, Venezuela and Qatar are now unable to increase output further because of economic or technical constraints, which means that they are either very close to or have reached maximum capacity at current prices. Therefore, the agreement probably required no sacrifices on their parts and implies that any output curtailments from the U.S. or Canada will not be filled in by a ramp-up from OPEC if prices are too low. Whatever the real underlying reason for the freeze, that absence of incremental production is important as it would increase the price-rebound potential from a reduced-supply response to lower energy levels.

The agreement was considered to be an introduction toward more meaningful cuts by OPEC down the road. We doubt this will be the case. It would defeat the purpose of the last two years of world oversupply (encouraged in part by the cartel) to flush out U.S. competition. Although risks of a material downturn in prices and potential bouts of extreme volatility are still present as inventories are reaching close to capacity in the U.S. (chart 2). We think the freeze will somewhat mitigate the probabilities of such occurrences, and help in the rebalancing of the supply-and-demand picture for the second half of 2016.

## As energy levels stabilize, so will Canada's stock market

During the last two years, Canada's S&P/TSX index suffered greatly from the severe downturn in commodity prices. The national economy is going through an adjustment phase with growth still evolving in a two-pronged condition characterized

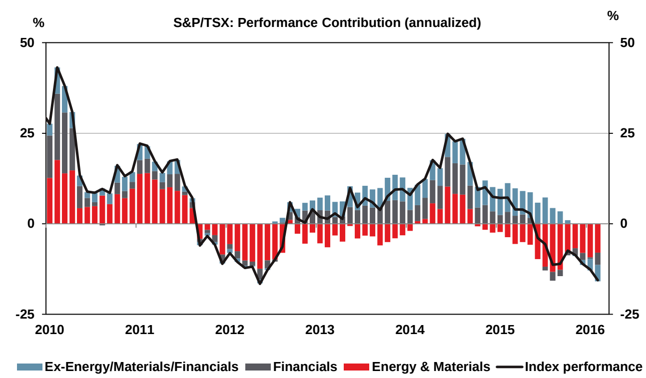
**Just weeks away from the end of injection season**




Source: Datastream, EIA
2

by the resource sector still contracting, while the rest of the economy is faring somewhat better. The Canadian stock market wasn't spared this difficult environment, with the index affected by its heavy representation in energy and basic materials companies (chart 3).

**As commodities rebound, so will the S&P/TSX**



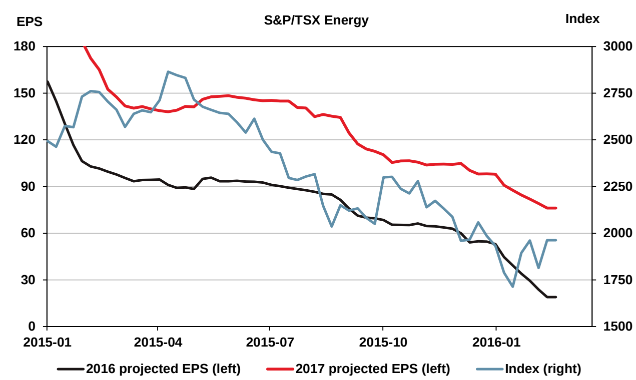

Source: Datastream
3

Canadian banks were also impacted by the downward pressure as investors feared growing energy loans losses and the collateral risk of further defaults in real estate mortgages in the crude producing regions. The fact that Bank of Canada (BoC) Governor Poloz mentioned he would consider negative rates if the country's economy continues to deteriorate puts even greater fear of pressure on net interest margins.

While the S&P/TSX greatly underperformed its peers (especially its U.S. counterpart) in recent years (chart of the month) we expect this trend to reverse itself over the next couple of months for multiple reasons:

1- Crude price-stabilization or rebound: As we discussed previously, we think we are close to a gradual improvement in the supply/demand balance in the oil space, which should put a floor on prices and stabilize earnings expectations for energy companies that have already been revised downward significantly from the 2015 year-end (chart 4). This will provide a reduction in fears tied to high-yield energy loans, and somewhat ease the financial pressure on enterprises operating in the sector. The market has largely discounted the divergence of the U.S. monetary policy with the rest of the world and, as such, the USD is likely to endure a gradual decline from peak levels, providing a catalyst for generally increasing commodity prices. The Canadian equity market should benefit more from this trend.

**Low expectations**




Source: Datastream, IBES
4

2- Better overall valuations and bank risk management: The most recent quarterly earnings reports from Canadian banks seem to indicate that provisions for credit losses (PCLs) from the sharp drop in crude prices are not as bad as expected. Furthermore, the indirect negative impact of mortgage and other consumer loan defaults are less important than first anticipated. The last financial crisis seems to have had a positive effect on risk management for financials and, as a result, we think the banks will weather the storm and perform better than previously expected.

3- Exports: U.S. consumption is still strong and non-commodity related companies can benefit via exports spurred by a weak Canadian dollar. Even if we anticipate the loonie will slowly appreciate in the coming months, we doubt it will revert back to levels witnessed in 2012-2013, and the favourable environment should persist for exporters.

4- Federal budget deficits: The government will be implementing sizeable and badly-needed fiscal stimuli in March, including infrastructure projects which should give a much needed boost to employment and consumption.

A combination of all of these factors should provide tailwinds for Canadian stocks over the course of the year. While the expected earnings growth rate seems to slightly favour Canadian stocks over their U.S. counterparts, the financial ratios are fairly similar between the Canadian and U.S. markets (table 2). Hence, the main driver for return divergence between the markets will depend largely on the first two points in the list above, as they will greatly impact the performance of commodity-related as well as financial companies which, in sum, represent close to half the weight of the S&P/TSX index.

**Table 2: Comparative Index Valuations**

| | S&P 500 | S&P/TSX |
|---|---|---|
| Trailing P/E | 16.4 | 16.7 |
| 12 months Forward P/E | 15.7 | 15.4 |
| Earnings Growth rate (12m) | 5.1% | 8.5% |

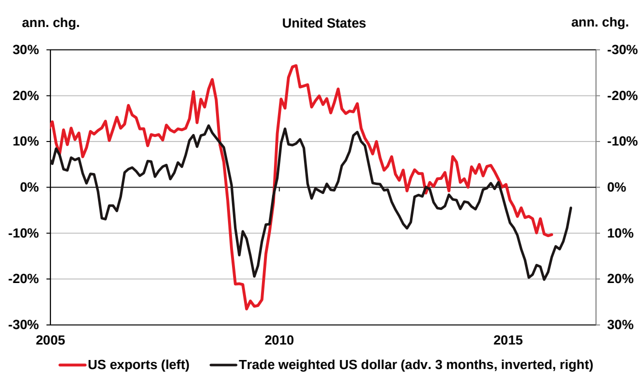
*source: IBES, Datastream*

## U.S. dollar: All eyes on Yellen and hike expectations

While the strength of the U.S. dollar certainly helps Canadian non-energy exports, the drag to trade is being felt south of the border (chart 5). The strong greenback generates problems overseas, as it also puts downward pressure on commodity prices and USD-denominated debt, both of which are major headwinds to emerging market economies.

The recent market turmoil caused by slowing global growth also generated a flight to quality that favored US treasuries which, when added to the Fed's policy divergence with other central banks, are the two main factors behind the currency's appreciation. If you thought the FOMC decisions would be smooth sailing after last December's hike, think again. The central bank is trying to balance the risks of a strong greenback with its inflation expectations and tightening bias. The

**A transitory effect on exports?**




Source: Datastream
5

committee is also well aware that financial risk and turmoil abroad do have an impact domestically and, as a consequence, such events need to be taken into account in its decision process:

> *"Domestic financial conditions tightened over the intermeeting period, as turmoil in Chinese financial markets and lower oil prices contributed to concerns about prospects for global economic growth and a pullback from risky assets. The increased reluctance to hold risky assets was associated with a sharp decline in equity prices and a notable widening in risk spreads on corporate bonds. Treasury yields declined across maturities, reflecting a downward revision in the expected path of the federal funds rate and likely some increase in safe-haven demands amid the market turbulence."*
>
> -FOMC Minutes from the January 2016 meeting

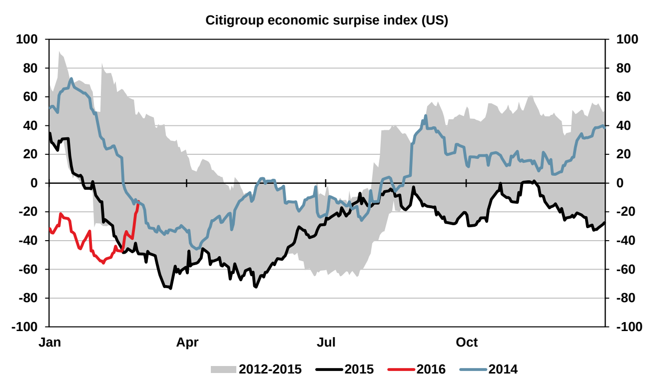
The committee also noted that should these conditions persist, the effects would be "roughly equivalent to those from further firming in monetary policy." Therefore, we shouldn't expect any change for March's meeting. The main factor to watch will be the "dot plot," that will tell us much more about the FOMC's intentions, as well as its reading of the current economic situation. We anticipate the members to sensibly reduce the projected number of hikes in 2016. However, that readjustment probably won't be enough to converge with market expectations which are much more dovish, calling for the equivalent of half a hike this year.

As usual, it will be up to Chair Yellen to bridge the gap between the two views, and the tightrope walk seems to increase in difficulty with each passing month. If she appears too hawkish or leans towards a strategy that's too restrictive compared to what is expected, the U.S. dollar will appreciate even more and amplify the problems we discussed previously. A 'too accommodating' tone or even totally abandoning the tightening bias would not help either. It would severely damage the bank's credibility and be interpreted as a sign the economy is struggling more than anticipated. This would, in turn, then increase fears of an economic downturn as well as financial market volatility, and defeat the initial purpose of a reversal of policy. The "wait and see approach" is a logical one, and the questions are: What will the Fed see in the coming months? And, are the fears of a U.S. abrupt slowdown founded?

While we are witnessing a soft patch at the beginning of the year, we've been there before (chart 6) and there's no reason to think this time will be any different. We still don't think a recession is in the cards. The strong greenback combined with the energy downturn certainly contributed to the fourth month in a row of contracting ISM manufacturing figures (48.2 in January), but the services were still expansionary at 53.5. The housing market is also very healthy (chart 7) and employment continues to be improving, albeit at a slower pace than in the previous year. However, as long as the U.S. keeps adding north of 100,000 jobs per month there's no real cause to worry.

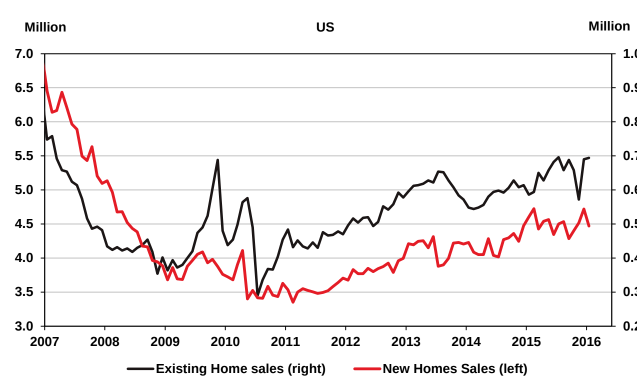
That employment pace should eventually start to have an impact on wage increases and inflation, which the Fed is watching with a close eye. Even if the figures have remained low, most of the effects from the energy downturn are transitory (chart 8, next page), and the goal is still the same as the one in 2015: slowly tighten policy to contain potential inflation in order to limit the chances of having to "slam on the brakes" later and adversely affect the economy.

**Third disappointing Q1 in a row!**



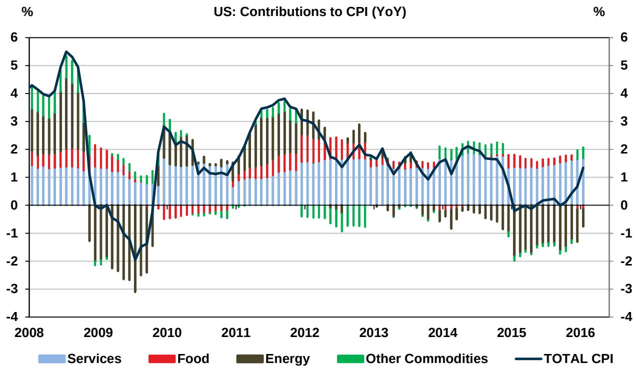

Source: Datastream
6

**Home sales are healthy and tending up**



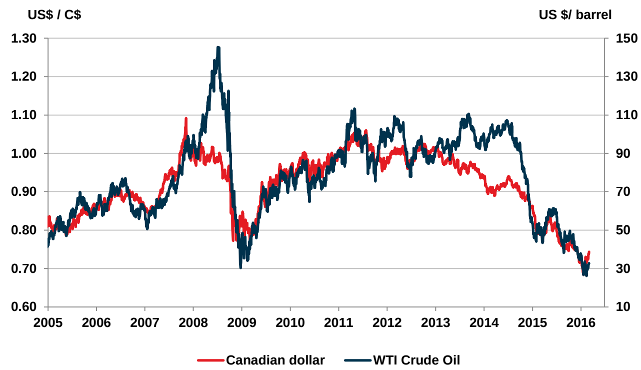

Source: Datastream
7

**How long before energy contributes to inflation?**




Source: Datastream
8

**Still tied at the hip**




Source: Datastream
9

## Asset Allocation

While we are aware of the risks underpinning global markets as well as the fears regarding a growth slowdown, we think stocks will outperform bonds in the medium to long term. The decrease in volatility from last month is a welcome development, and picking bottoms to slowly increase exposure as markets stabilize may be the best course of action. However, we would advise caution before extending risk too much.

Crude oil prices are still exposed to a sharp decrease in prices caused by physical inventory constraints, but we think the recent tentative agreement between OPEC and Russia is marking the beginning of a long and deliberate recovery for the sector. As a consequence, we think the Canadian stock market is poised to take advantage of the eventual strengthening in prices and we would favor the S&P/TSX over its U.S. counterpart.

The story is the same for the Canadian dollar. We think hedging the exposure at the current levels against the U.S. dollar will prove wise for investors who have a medium- to long-term horizon, as the currency pairing is tied to crude oil's performances (chart 9).

In fixed income, as the market is in flux and there's more uncertainty about the Fed's view of the markets, we think being neutral (both duration- and credit-wise) is the best course of action until the Fed meeting (and dot plot), which would give us a clearer picture of what lies ahead.

## 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 |
|---|---|---|---|---|---|
| **Liquidité** | | ■ | | | |
| **Obligations** | | ■ | | | |
| (Durée) | | ■ | | | |
| **Fédérales** | ■ | | | | |
| **Catégorie investissement** | | ■ | | | |
| **Rendement élevé (USD)** | | | | ■ | |
| **Revenus non traditionnels** | | | | ■ | |
| **Actions mondiales** | | | | ■ | |
| **S&P/TSX** | | | ■ | | |
| **S&P 500 (USD)** | | | | ■ | |
| *Croissance vs Valeur* | | | ■ | | |
| *Grandes cap. vs Petites* | | | | ■ | |
| *Défensif vs cyclique* | | ■ | | | |
| **MSCI EAFE (USD)** | | | | ■ | |
| **MSCI EM (USD)** | | ■ | | | |
| **Produits alternatifs** | | | ■ | | |
| **Commodités** | | | ■ | | |
| *Pétrole* | | | | ■ | |
| *Métaux de base* | | | | ■ | |
| *Or* | | ■ | | | |
| **Fonds de couverture (USD)** | | | ■ | | |
| **Fonds immobiliers** | | ■ | | | |

Source: Consulting Investment Committee