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INVESTING

Asset Allocation Strategy

A Brexit or hike surprise in June?

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Highlights

- The FOMC's complicated relationship with market expectations continues and the probabilities of tightening have certainly increased when Chair Yellen said it would be appropriate "for the Fed to gradually and cautiously increase our overnight interest rate over time, and probably in the coming months."
- While most of the global risks dogging the markets at the end of 2015 and beginning of 2016 seem to have subsided (Yuan, crude oil prices and credit spreads), a hike in June would be ill-timed as China is struggling to generate some momentum and the EU has to contend with the uncertainty generated by a Brexit vote.
- Brexit: Even is the 'remain' camp appears to be slightly ahead in the polls, they lead by only a small margin and, at this point, it remains a coin toss. We think volatility regarding the Euro and stock markets would dramatically increase if the 'leave' camp gains some steam ahead of the June 23 vote.
- Even though we are past the recent highs, we believe the Canadian dollar has limited upside for now, and that investors should wait for better levels before adding to their hedge positions.
- On crude oil, we think $50 will prove too much of a resistance to justify further appreciation in the near future.
- The S&P 500 is also hitting resistance levels, while its financial ratios have now reverted to levels witnessed before the corrections.
- Before the next leg up, companies will have to show some form of earnings growth, and that has proven difficult to achieve in recent months.

Table 1 Global Asset Allocation

Global Classes	−		*Weights*		+
Cash				■	
Fixed Income		■			
Equities			■	░	
Fixed Income					
Federal		■			
Investment Grade			■		
High Yield (USD)				■	
Non-Traditional FI				■	
World Equities					
S&P/TSX			■	░	
S&P 500 (USD)			■		
Growth vs. Value			■		
Large vs Small cap.		■			
Defensives vs Cyclicals		■			
MSCI EAFE (USD)			■	░	
MSCI EM (USD)		■			
Alternative Investments					
Currency Hedge				■	
Commodities			■		
Energy		■	░		
Base Metals			■		
Gold			■		
Hedge Funds			■		
REITS / Infrastructure		■			

Source: Consulting Investment Committee

Current Allocation ■
Previous Month Allocation ░

NATIONAL BANK

Market review

Fixed income

- Bond market rebound of 0.9% with a slight flattening of the curve in the medium and long-term tenor.
- Lower grade companies contributed the bulk of the corporate bond's positive performance.
- After producing sharp appreciation in the last three months, preferred share securities and high-yield bonds stabilized to generate modest gains in May.

Canadian equities

- Gain of 1.0% supported by the financial services sector (1.5%) as banks and insurance companies would stand to benefit from a more hawkish rate hike outlook.
- The defensives such as consumers, telecoms and utilities also contributed to the overall performance.
- The potential of rising interest rates and the U.S. dollar appreciation had negative impact on gold stocks, resulting in a decrease of 6.6% of the basic materials sector.

U.S. equities

- The sectors that posted a loss in the first four months of the year (technology and health care), supported the market rebound in May while high-performance sectors since the beginning of 2016 (energy and basic materials), were practically flat for the month.
- The perspective of a rate hike has also been beneficial to the financial services sector and in particular banks and insurance companies.

Commodities

- The temporary closure of nearly 1 million barrels per day of oil sands operations in Alberta resulted in a significant increase in oil prices.

Foreign exchange

- The Fed's growing desire to implement a more restrictive monetary policy pushed the loonie lower, while the Euro had to contend with the additional selling pressure tied to uncertainty generated by the Brexit vote.

Table 2 **Market total returns**

Asset classes	May	YTD	2015
Cash (3-month T-bills)	0.1%	0.2%	0.6%
Bonds (FTSE/TMX Ovr. Univ.)	**0.9%**	**2.2%**	**3.5%**
FTSE/TMX Short term	0.3%	0.6%	2.6%
FTSE/TMX Mid term	1.2%	2.3%	4.9%
FTSE/TMX Long term	1.4%	4.4%	3.8%
FTSE/TMX Government	1.0%	2.1%	3.8%
Federal	1.0%	1.4%	3.7%
Provinces	1.0%	2.8%	4.1%
Municipales	1.1%	2.5%	3.2%
FTSE/TMX Corporate	0.7%	2.7%	2.7%
AA+	0.5%	1.6%	3.0%
A	0.7%	2.9%	2.6%
BBB	0.8%	3.5%	2.5%
BoAML High-Yield (USD)	0.7%	8.1%	-4.6%
Preferred shares	0.5%	-2.3%	-14.9%
Canada (S&P/TSX)	**1.0%**	**9.5%**	**-8.3%**
Energy	1.5%	17.1%	-22.9%
Industrials	1.4%	6.3%	-11.1%
Financials	1.5%	7.8%	-1.7%
Materials	-6.6%	34.7%	-21.0%
Utilities	3.6%	12.6%	-3.5%
Cons. Disc	3.6%	4.9%	-1.5%
Cons. Staples	4.7%	5.9%	12.4%
Healthcare	-6.7%	-64.9%	-15.6%
IT	8.4%	1.4%	15.6%
Telecom	3.5%	11.9%	3.6%
S&P/TSX Small cap	-0.3%	21.6%	-13.3%
US (S&P500 / USD)	**1.8%**	**3.6%**	**1.4%**
Energy	-0.6%	12.4%	-21.1%
Industrials	-0.5%	5.4%	-2.5%
Financials	2.0%	0.2%	-1.5%
Materials	-0.3%	8.4%	-8.4%
Utilities	1.5%	14.5%	-4.8%
Cons. Disc	0.1%	1.9%	10.1%
Cons. Staples	0.8%	5.0%	6.6%
Healthcare	2.2%	-0.6%	6.9%
IT	5.6%	2.5%	5.9%
Telecom	0.0%	14.2%	3.4%
Russell 2000 (USD)	2.1%	1.7%	-5.7%
World eq. (MSCI ACWI / USD)	**0.2%**	**2.1%**	**-1.8%**
MSCI EAFE (USD)	-0.8%	-0.7%	-0.4%
MSCI EM (USD)	-3.7%	2.4%	-14.6%
Commodities (CRB index)	**-1.3%**	**10.0%**	**-14.4%**
WTI oil (US$/barrel)	6.1%	31.4%	-30.9%
Gold (US$/ounce)	-6.0%	14.3%	-10.4%
Copper (US$/tonne)	-7.3%	-0.2%	-26.1%
Forex (DXY - US Dollar index)	**3.0%**	**-2.8%**	**9.3%**
USD per EUR	-2.8%	2.5%	-10.2%
CAD per USD	4.3%	-5.4%	19.1%

Source: Datastream 05/31/2016

Fed minutes: Recalibrating expectations

The FOMC's complicated relationship with market expectations continues as the Central Bank is constantly blowing hot and cold about the potential tightening of its monetary policy. The most recent chapter in this ongoing story has been April's Fed Meeting minutes released on May 18, 2016. While the original statement was interpreted as fairly non-committal towards the timing of a future hike, the minutes served as a stark reminder that the members are still on the tightening path, and actions could come earlier than previously thought:

> *"Most participants judged that if incoming data were consistent with economic growth picking up in the second quarter, labor market conditions continuing to strengthen, and inflation making progress toward the Committee's 2 percent objective, then it likely would be appropriate for the Committee to increase the target range for the federal funds rate in June."*
>
> \- FOMC minutes for the April 26-27, 2016 meeting

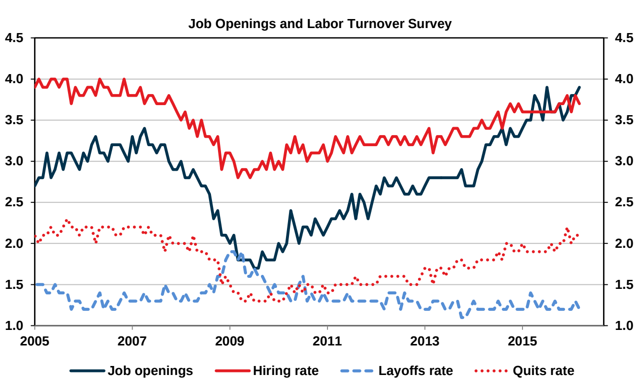
The members expressed some concerns about the confusion generated by postponement of action, the erosion of the Committee's credibility, and undue risk-taking stemming from an overly accommodative policy. Some participants even highlighted the gap between the current target and what most of the internal models predict the rate should be, which poses a risk of overshooting the Fed's inflation target.

The FOMC is focusing mainly on employment which continues to show vigor (chart 1). While there is still some slack, the rise in the participation rate was deemed a "positive development, suggesting that a tighter labor market could potentially draw more individuals back into the workforce in a sustained basis." Inflation is also showing signs that we are now off the lows and set to increase (chart 2). As the statement following the April rate decision hinted, members seemed unswayed by the weak Q1 GDP numbers, citing possible measurement problems or transitory factors.

It was also noted that most of the global risks dogging the markets at the end of 2015 and beginning of 2016 seem to have subsided. Fears about China devaluing its currency are less salient, crude oil prices have materially rebounded, and credit spreads have further tightened (chart 3).

Even though there seems to be an open window for action, there is still a disagreement between the Fed's view and what investors believe should be the appropriate timing for a hike. Since other major central banks are in a very accommodative mood, continued policy divergence from the U.S. would risk pushing the USD higher, if the hiking schedule is too aggressive. Such an occurrence could be detrimental to exports and manufacturing, both of which have been struggling ever since

Positive developments, no matter where you look



Source: Datastream
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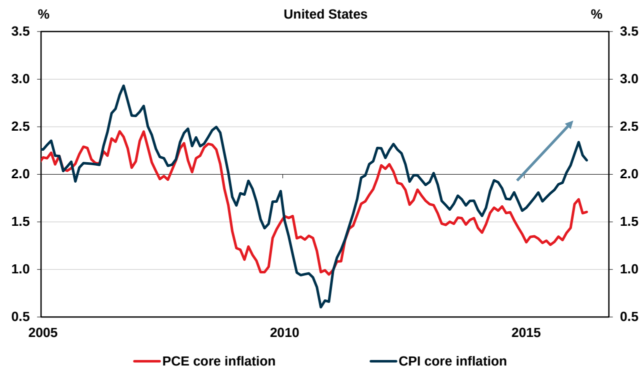
The last months were weaker, but the trend is still there



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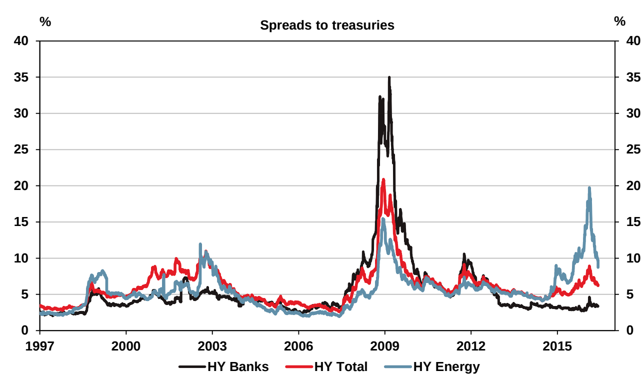
Credit can breathe a little easier



Source: Datastream
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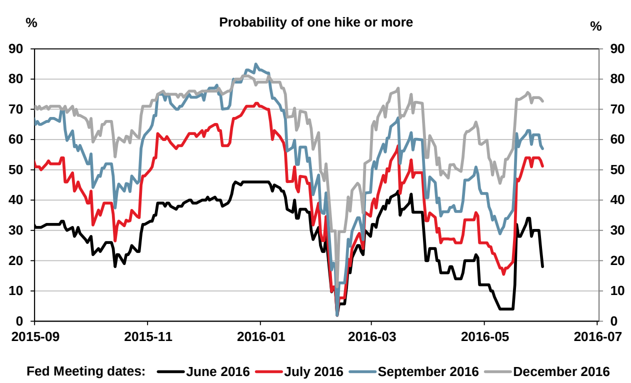
the greenback surge in 2014. The lack of business investment is also worrying, especially when we consider how companies had access to cheap credit. Share buy-back programs were instigated instead of implementing new projects, which is usually a poor signal about how management views earnings growth prospects.

Globally, a stronger greenback also puts additional pressure on emerging market countries with USD-denominated debt, and has the potential to revive some of the sovereign credit fears we witnessed last year. A hike in June would be ill-timed, considering that China is still deep in its transition phase towards a consumer-based economy and struggling to generate some momentum, while the EU has to contend with the uncertainty generated by a Brexit vote (see box 1 at the end of the document).

Nevertheless, the probabilities of tightening have certainly increased materially since the minutes. In a speech on May 27, Chair Yellen said it would be appropriate "for the Fed to gradually and cautiously increase our overnight interest rate over time, and probably in the coming months." The previous time she made a similar statement, she kept her promise - but waited until the very last minute in December 2015.

A jump, but still a coin toss for a hike by July



Source: Datastream

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Therefore, one wonders whether June is really 'a given' for a hike (chart 4)?

Two points constant throughout the months have been the Central Bank's data dependency and its caution towards generating undue volatility. The FOMC now seems to have shifted toward a scenario where employment numbers fitting the recent trend coupled with no major exogenous risks emerging would be considered "good enough" for policy actions. We think the polling numbers regarding a possible Brexit and economic figures (especially the ones tied to employment) between now and the next rate decision on June 15 will play large roles in deciding if the time is right or not.

Fixed income: All eyes on the Fed

Whether the Central Bank decides to act in June, July or further down the road, the yields will eventually follow suit. The only points that could be considered positive for bonds are a very soft labour market report (our economics and strategy team is forecasting only 90k net job creation for the month of May), or a possible flight to safety generated by a Brexit which, as of now, we would consider a longshot. Therefore, we suggest investing in shorter duration bonds with higher yields.

Preferred shares should also be favoured, as higher energy prices tied to reduced loan risks in the space are benefitting financial companies which form a big proportion of the asset class. Due to its current high after-tax yield-to-worst, preferred shares continue to be the most compelling credit play. With better-priced new issues now part of the index, and with less risk of a surprise drop in short-term interest rates, the 'catch-up' effect should continue for a while longer

Currencies: Policy divergence may have an impact

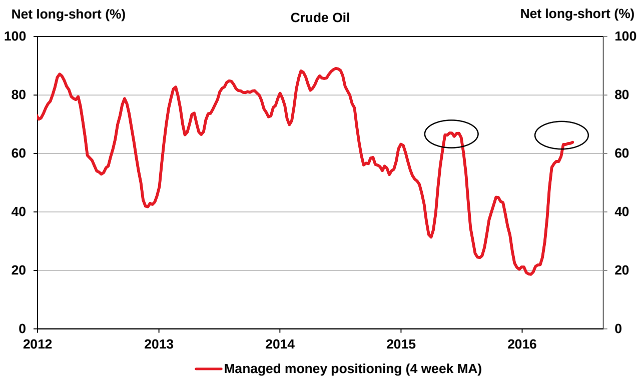
The greenback rebounded nicely this month, in light of the uncertainty tied to Brexit, and the markets' reassessments of potential Fed rate hikes in the coming months.

While the loonie is usually tied to energy prices, it wasn't the case this month as the currency, despite oil prices flirting with the 50 dollar mark, depreciated somewhat. The spread in short-term interest rate with its U.S. counterpart is the main explanation behind this sudden weakness. This has helped the loonie revert back to more reasonable levels after a 15% gain in about just three months. We believe commodities will also eventually lose some steam (see below). Consequently, even though we are past the recent highs, we think the Canadian dollar has limited upside for now, and that investors should wait for better levels before adding to their hedge positions.

Commodities: Time for a breather?

The recent run in crude since the lows in February has been nothing short of spectacular. However, we think $50 will prove too much of a resistance to justify further appreciation in the near future. Speculators have now very much tilted on the long side (chart 5, next page) and current price levels are deemed attractive for producers to start hedging which should generate even more selling pressure. Added to the prospect of U.S. dollar appreciation, we think the energy complex will face strong headwinds in the coming months. Although we see some downside risks on the short-term horizon, the medium/long-term picture remains fairly attractive, as the supply and demand picture will eventually rebalance and prices should witness a slow and deliberate appreciation.

Long speculation back to 2015 highs



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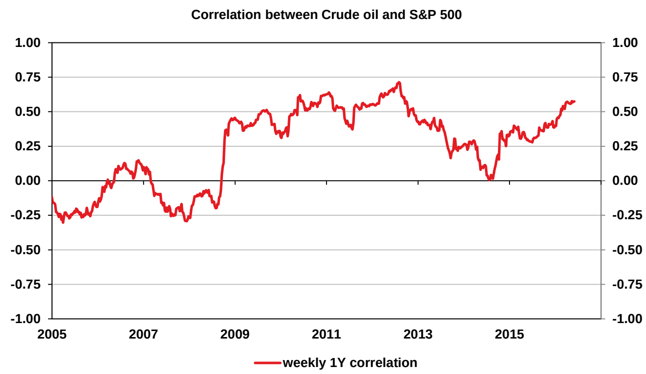
Crude increasingly served as a risk-on/off indicator



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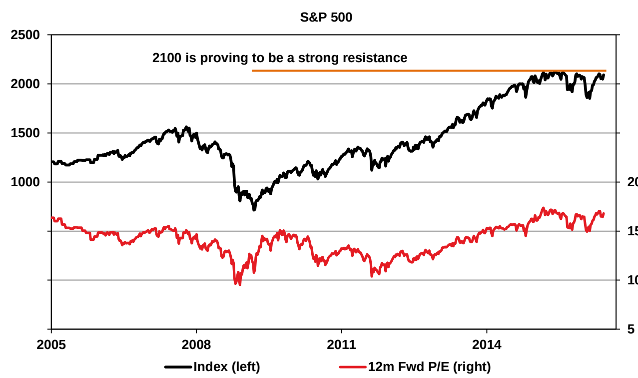
Equities: Ratio expansion has its limits

The story is the same for equities, as the asset class's correlation to oil prices is back to the highs of previous years (chart 6). The S&P 500 is also hitting resistance levels, while its financial ratios have now reverted to levels witnessed before the corrections (chart 7). Before the next leg up, companies will have to show some form of earnings growth, and that has proven difficult to achieve in recent months (chart 8).

For Canadian equities, we think their underperformance (due to the energy downturn) has been largely priced in, and the weak Canadian dollar should help earnings going forward. While there is a risk of a short-term pullback, longer-term prospects continue to look good on a relative basis.

The tightening of the Fed policy will be interpreted as bearish for the overall equity markets. However, we think it will be countered by the relatively-healthy underlying domestic economic situation in the U.S. and, as a consequence, we still favour equities as they are poised to offer better return prospects on the medium/long term horizon than those from fixed income.

Headwinds on the horizon



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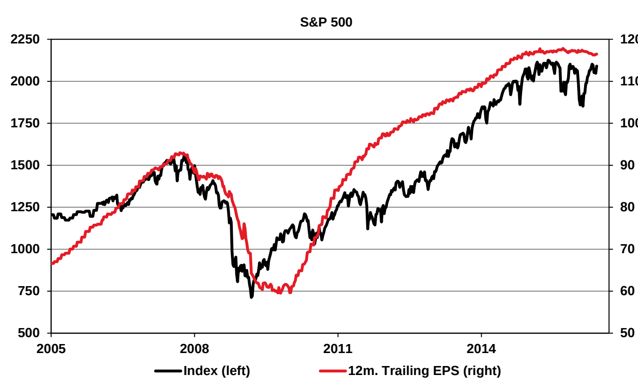
No growth = no returns



Source: Datastream

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Box 1: Brexit Guide

The last few years have certainly been a challenge for the EU: the 2008 financial crisis, Grexit, migrant crises, general rise of nationalism, and Euroscepticism have all put a dent in the strength of the Union. The latest chapter is now Brexit, set to conclude by referendum in June. Here's a rundown and overview of the situation to help in assessing the risks leading up to the vote… and the aftermath.

Timeline:

1. **January 2013:** Following some disillusionment with the EU (and some internal pressure from Eurosceptic MPs for his party), David Cameron pledged a referendum would be held before the end of 2017, should the Conservatives win the next election. The promise implied that he would renegotiate the standing agreement between the EU and the UK, then submit those new terms to an 'in/out' vote.
2. **May 7, 2015:** The Conservative Party wins an unexpected majority, thus starting the process towards a tentative agreement and Brexit vote.
3. **February 18-19, 2016**: PM Cameron emerged from a marathon negotiation session with various leaders of the EU with new terms regarding Britain's 'special status' within the Union.
4. **June 23, 2016**: Referendum vote on whether to stay in the Union with the new terms or to leave.

Politicians arguing for staying in the Union: Although his Conservative party vowed to officially remain neutral in the debate, its leader, PM David Cameron is campaigning for the 'stay' camp, assisted by the Labour Party, the Scottish National Party, the Liberal Democrats, and three former Prime Ministers (John Major, Tony Blair and Gordon Brown). Most foreign and business leaders would also prefer a 'stay' outcome.

Politicians arguing for leaving the Union: This group includes Eurosceptic Conservatives (such as former London Mayor Boris Johnson), roughly half of the Conservative MPs, as well as the UK Independence Party.

Main issues debated: While the vote has broad consequences socially, we will focus on the ones that have economic and financial impact.

- **Budget and free trade:** The 'leave' camp argues that Britain contributes much more to the EU budget than it receives. In 2015, the contributions were close to £13 bn ($US 18 bn) while they received £4.5 bn ($US 6.3 bn). This shortfall accounted for about 12% of the ongoing UK deficit. It was emphasized that the Union is too focused on internal exchange of goods at the expense of emerging markets, as there is no specific trade deal with China or India.

  The 'stay' side counters by highlighting that close to 50% of Britain's exports go to other EU countries. Also, leaving the Union would risk implementing new barriers to exports, while new potential trade agreements with the EU (or emerging markets) would be years away. The U.S. also stressed that it would prioritize the ongoing talks for a trade deal with the EU over new negotiations with Britain, should the UK leave the Union.

- **Laws and financial regulations**: Advocates for the 'leave' camp declare that the laws implemented by Brussels do not always serve Britain's interests, they act as a drag on growth, and are costly for business.

  The 'remain' camp points to the benefit of having only one major market, signalling banking as an example. Leaving the Union would mean that new licences or rules would have to be followed by international banks based in the UK in order to do business, and that loss of 'passport for business' would drastically reduce London's competitive advantage in the field.

- **Economics**: Most economists and the 'stay' camp argue that following a 'leave' outcome, the economy would suffer. Underlying uncertainty would reduce private investment and household spending, while could also possibly hurt the real estate market and capital flows into the UK --- the worst-case scenario being that the country would fall into a recession.

  Proponents of the 'leave' group think the transition wouldn't be as painful as advertised by the opposing clan, and that Brexit would be of the 'short-term-uncertainty-for-long-term-gain' type.

Market risks tied to the vote: Predicting the consequences of a 'stay' win is easier as it would indicate *status quo*. Even if this camp appears to be slightly ahead in the polls, they lead by only a small margin and, at this point, it remains a coin toss. We think volatility regarding the Euro and stock markets would dramatically increase if the 'leave' camp gains some steam ahead of the June 23 vote.

Should Brexit eventually happen, European banks (already burdened with debt problems) would face additional challenges and be at risk of a material downturn. The Euro and European stocks would also be subject to increased selling pressure as a 'leave' vote would be considered bad not only for the UK, but also for the EU.

Globally, we expect the financial market turmoil to generate a flight-to-quality toward U.S. treasuries, giving additional strength to the U.S. dollar.