INVESTING

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Asset Allocation Strategy

All that glitters is not gold

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Highlights

- The most important reason for gold's appreciation has certainly been the bond markets. We are in uncharted territory regarding sovereign debt as 70% of global government bonds are yielding less than 1%, and 30% are even in negative yield territory. Such an environment is usually considered very constructive for gold as investors incur very little opportunity costs in owning the metal while implementing an effective hedge against potential inflation.
- Central bank policies combined with generalized risk aversion have now pushed fixed income assets toward extreme levels as investors are now stuck between a rock and a hard place where they must either take on greater risk by moving their investments into lower-credit rating classes or contend with subpar potential returns.
- As we expect the Fed will tighten its policy sooner than anticipated, we suggest taking a defensive position duration-wise while being more aggressive on the credit side. Such positioning will offer higher yields and mitigate the impact of a potential hike.
- For the U.S. dollar, the next quarters could show two opposing forces. While we expect that the timing of the Fed hike may help the greenback appreciate, we think the underlying global environment permitting such action would counter the effect, as this would mean the central bank thinks global risks are contained, thus reducing the US dollar's attractiveness as a safety asset.
- In crude oil, we still expect the supply- and-demand picture to be balanced by the end of the year. U.S. domestic production is close to 1 million bpd less than at the peak witnessed earlier this year. Yes, the rig counts are increasing, but they are still materially lower than 12 months ago. However, inventory levels are much higher, which means any surprise in oversupply has the potential to be met with a substantial price decrease.

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

Market review

Fixed income

- As Brexit fears waned, U.S. 10-year securities rebounded slightly from the low of 1.39% at the beginning of the month to close July at 1.46%.
- Their Canadian counterparts witnessed the same movements, setting the benchmark for a flat showing in July.
- The 0.5% decrease in high-yield spreads helped the index register another solid month, bringing the year-to-date performance to an impressive 12.1%.

Canadian equities

- Good breadth of market as 9 out of 10 sectors posted positive numbers this month, helping the index record 3.9% for July.
- Despite crude oil's lackluster performance, the energy sector showed a lot of resilience, losing only 0.4% for the period.
- In materials, the gold subsector continued the trend set in January with an increase of 8.4% for the month.

U.S. equities

- The S&P 500 quickly broke the 2100 trend line at the beginning of the month, but then lost steam and stuck in a very tight range around 2160 for the rest of the period.
- Crude oil's decline had an impact on companies in the energy sector, which was the worst contributor this month.
- With an average appreciation of 5.3%, the early cyclicals (IT, Consumer discretionary and Financials) pushed the index up, while the higher dividend paying sectors (Telecom Utilities and Consumer Staples) were a drag compared to other sectors.

Commodities

- Dragged down by the inventory overhang, crude oil recorded its worst monthly performance since January 2015.
- Even though the fears tied to Brexit abated somewhat, gold posted a very respectable 2.1% for July.

Foreign exchange

- The U.S. dollar steadily gained throughout the month as the expectations were high for easing from the ECB, BoE and BoJ. However, the BoJ disappointed the markets with a weaker stimulus than expected and the greenback dropped as a result.
- As expected, the loonie lost 0.8% in light of the crude oil downturn.

Table 2 Market total returns

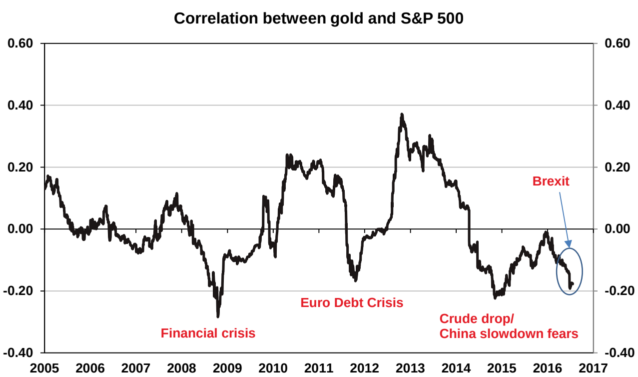
Asset classes	July	YTD	2015
Cash (3-month T-bills)	0.0%	0.3%	0.6%
Bonds (FTSE/TMX Ovr. Univ.)	**0.8%**	**4.9%**	**3.5%**
FTSE/TMX Short term	0.1%	1.2%	2.6%
FTSE/TMX Mid term	0.5%	4.5%	4.9%
FTSE/TMX Long term	2.0%	10.5%	3.8%
FTSE/TMX Government	0.9%	5.0%	3.8%
Federal	0.4%	3.2%	3.7%
Provinces	1.4%	6.8%	4.1%
Municipales	1.2%	5.9%	3.2%
FTSE/TMX Corporate	0.7%	4.8%	2.7%
AA+	0.2%	2.4%	3.0%
A	1.1%	5.8%	2.6%
BBB	0.8%	5.7%	2.5%
BoAML High-Yield (USD)	2.5%	12.1%	-4.6%
Preferred shares	3.6%	0.6%	-14.9%
Canada (S&P/TSX)	**3.9%**	**14.1%**	**-8.3%**
Energy	-0.4%	18.8%	-22.9%
Industrials	7.7%	13.4%	-11.1%
Financials	3.4%	8.7%	-1.7%
Materials	6.9%	62.9%	-21.0%
Utilities	3.0%	20.8%	-3.5%
Cons. Disc	5.6%	5.7%	-1.5%
Cons. Staples	5.3%	8.1%	12.4%
Healthcare	6.4%	-70.6%	-15.6%
IT	9.2%	3.0%	15.6%
Telecom	4.4%	19.9%	3.6%
S&P/TSX Small cap	5.5%	35.0%	-13.3%
US (S&P500 / USD)	**3.7%**	**7.7%**	**1.4%**
Energy	-1.9%	13.9%	-21.1%
Industrials	3.4%	10.1%	-2.5%
Financials	3.5%	0.4%	-1.5%
Materials	5.1%	12.9%	-8.4%
Utilities	-0.7%	22.6%	-4.8%
Cons. Disc	4.6%	5.3%	10.1%
Cons. Staples	-0.7%	9.7%	6.6%
Healthcare	4.9%	5.4%	6.9%
IT	7.9%	7.5%	5.9%
Telecom	1.0%	26.1%	3.4%
Russell 2000 (USD)	5.9%	7.4%	-5.7%
World eq. (MSCI ACWI / USD)	**4.3%**	**6.0%**	**-1.8%**
MSCI EAFE (USD)	5.1%	0.8%	-0.4%
MSCI EM (USD)	5.1%	12.0%	-14.6%
Commodities (CRB index)	**-1.2%**	**8.9%**	**-14.4%**
WTI oil (US$/barrel)	-14.3%	11.9%	-30.9%
Gold (US$/ounce)	2.1%	27.0%	-10.4%
Copper (US$/tonne)	1.6%	4.5%	-26.1%
Forex (DXY - US Dollar index)	**-0.6%**	**-3.1%**	**9.3%**
USD per EUR	0.7%	2.9%	-10.2%
CAD per USD	-0.8%	5.9%	-19.1%

Source: Datastream 07/29/2016

Gold: What's behind the move?

Gold holds a special place in investors' minds as it seems to fulfill different roles depending on who's buying the precious metal. More and more investors are turning to the precious metal as a tool for diversification from the equity markets (chart 1). The 27% appreciation since the beginning of the year has been impressive. It has certainly helped the S&P/TSX's performance, as the gold miners now represent close to 9% of the index. Compared to other commodities such as energy products or even industrial metals, gold levels have a very limited impact economically. However, an analysis of the causes underpinning the move is much more interesting, as it gives us a glimpse into market sentiment or investor positioning.

When the going gets tough, gold's correlation changes



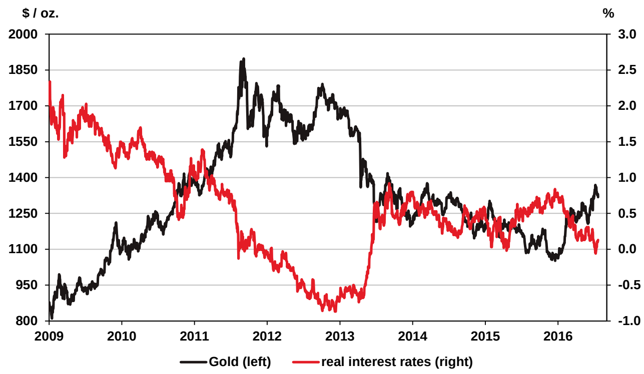
Source: Datastream

1

The most important reason for the recent appreciation has certainly been the bond markets. We are in uncharted territory regarding sovereign debt as 70% of global government bonds are yielding less than 1%, and 30% are even in negative yield territory. As we can see in chart 2, such an environment is usually considered very constructive for gold as investors incur very little opportunity costs in owning the metal while implementing an effective hedge against potential inflation.

While the QE's impact can be felt across the yield curve, one cannot ignore how the worldwide central bank rhetoric promoting easier policies can also influence gold's performance. In light of the uncertainty generated by Brexit, the ECB and BoE announced they will remain very accommodative for the foreseeable future, and are prepared to act should the situation justify it. In Japan, despite BoJ governor Kuroda's recent ruling out of the "helicopter money" option, the fact that it was considered a possibility by the markets only reinforces the appetite for assets like precious metals which can act as a store of value.

Lower real rates greatly favors gold



Source: Datastream

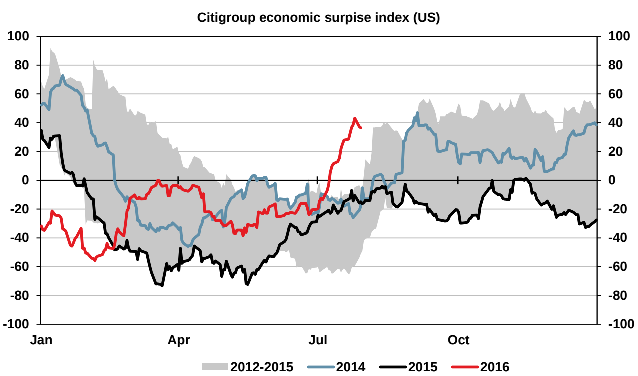
2

The Fed is currently the only major central bank considering an increase of its target rate to reign in potential inflation. But, in recent months we have seen the FOMC members constantly push back the timing of the next hike in order to preserve global market stability. This new monetary policy stance, in which foreign developments are factors in Chair Yellen's decision process, provides a serious tailwind to gold prices, especially in light of China's weakening Yuan, political turmoil in the U.S., Italy's banking problems and even the surprise Brexit vote. Usually, the traditional safe-haven status enjoyed by the precious metal when such events unfold is now reinforced by increased probabilities of Fed inaction which pushes real rates even lower domestically.

When deciding on the path of future hikes, those risks come in direct conflict with the central bank's domestic situation, which is still healthy. Nonfarm payrolls coming in at 287,000 is an indication that employment rebounded nicely since last month's numbers and the Citigroup Economic Surprise Index hasn't been this high in a long time (chart 3, next page). The statement following the Fed's rate decision of July 27 seems to slightly be opening the door towards monetary tightening by the end of the year. Any sign of rising inflation and continued improvement of the domestic labor market will be interpreted as a green light for a hike, and detrimental for the precious metal.

So, what's next? Speculation is a factor to consider as the convergence from extreme levels usually coincides with reversal in trader positioning (chart 4, next page). However, we think global macro developments in the coming quarters will determine the next leg up or down as gold seems to be taking its rightful place as a barometer for global risks and central bank policies (chart 5, next page).

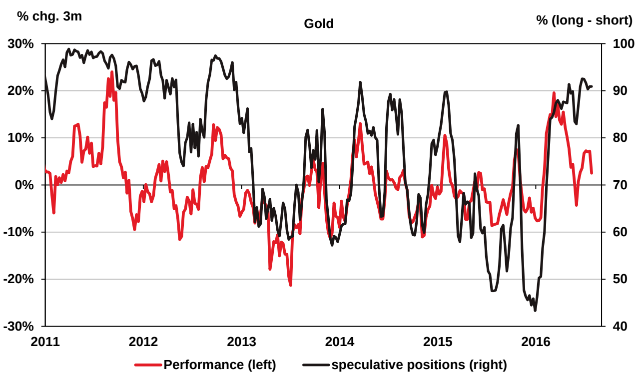
A long-awaited positive breakout



Source: Datastream

3

Speculative reversal coincides with price reversal



Source: Datastream

4

Global environment will determine gold's path

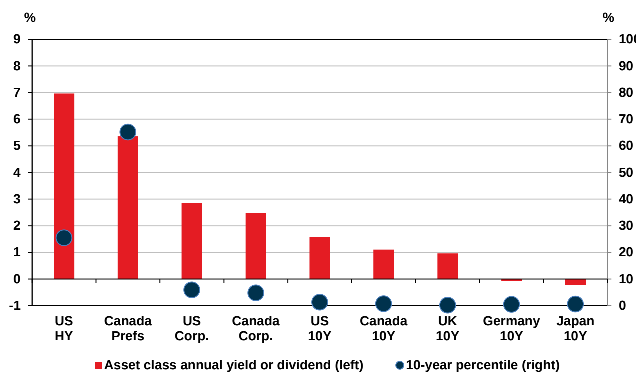
Source: Datastream

5

Fixed income: Yield vs. safety

As Brexit fears waned, the probabilities of a hike rose back to pre-referendum levels , while U.S. bond yields still have not fully recovered. Central bank policies combined with generalized risk aversion have now pushed fixed income assets toward extreme levels as investors are now stuck between a rock and a hard place where they must either take on greater risk by moving their investments into lower-credit rating classes or contend with subpar potential returns (chart 6). Another consequence of the current environment has been that duration of these fixed-income assets has constantly increased, the implication being if you invest in treasuries, not only will the expected returns be lower, but you will also be taking on higher risk in doing so.

To get higher returns, you need to take higher credit risk



Source: Datastream

6

The domestic economy has shown resilience and rebounded nicely since the soft patch we witnessed recently, and the Brexit impact looks to be fairly well contained. As a consequence, we expect the Fed will tighten its policy sooner than anticipated, and we suggest taking a defensive position duration-wise while being more aggressive on the credit side. Such positioning will offer higher yields and mitigate the impact of a potential hike.

Currencies: Fed vs. flows

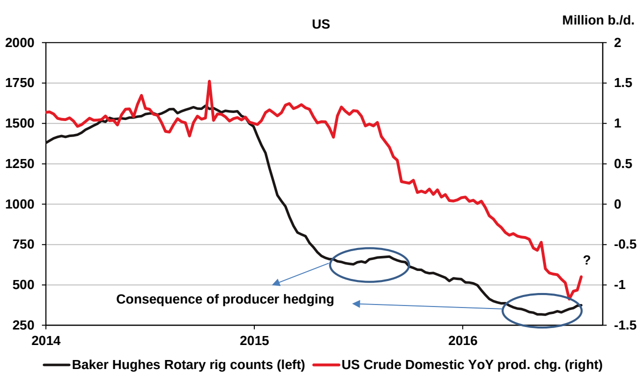
For the U.S. dollar, the next quarters could show two opposing forces. While we expect that the timing of the Fed hike may help the greenback appreciate, we think the underlying global environment permitting such action would counter the effect, as this would mean the central bank thinks global risks are contained. Decreased fears tied to a Chinese slowdown or Brexit aftermath would reduce 'flight to safety' stress and some of the flows to U.S. treasuries, which should put some pressure on the greenback. We think the range witnessed since the beginning of the year should persist for some time.

The loonie hasn't moved much since May and we do not foresee any major changes in the near future, unless crude oil breaks out materially from current levels (see next section below). Therefore, we suggest taking a neutral approach regarding currency hedges until we get a clearer picture about the next trend.

Commodities: 2015 vs. 2016

We continually stressed that oil's rebound since the beginning of 2016 could be self-defeating in nature because of the likelihood that companies would take such an opportunity to hedge their production and lock in fairly attractive profit margins – a scenario we witnessed in 2015. It now seems that our fears were well-founded (chart 7), as WTI has now lost 23% since its June highs.

How much damage will the increased activity do?



Source: Datastream

7

There are some differences between this year's downturn and the previous one. Contrary to 2015, we still expect the supply-and-demand picture to be balanced by the end of the year. U.S. domestic production is close to 1 million bpd less than at the peak witnessed earlier this year. Yes, the rig counts are increasing, but they are still materially lower than 12 months ago.

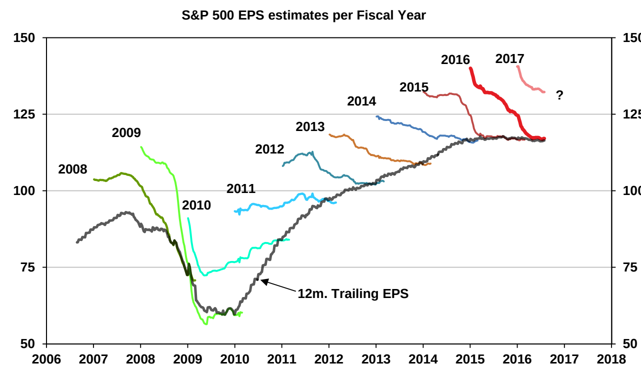
However, inventory levels are much higher, which means any surprise in oversupply has the potential to be met with a substantial price decrease. While the probabilities of such an event are fairly low compared to last year when Iran entering the world markets was the big elephant in the room, they are still present and cannot be ignored.

We doubt the downturn will be as violent as what we witnessed during the second half of 2015, but the energy markets will face some headwinds in the coming months. In light of the big inventory overhang, the recovery will take some time and will be prone to downturns here and there. But, the medium- to long-term fundamental picture is improving and should help maintain crude oil prices for the remainder of the year.

Equities: Monetary policy vs. valuations

The recent run-up for the S&P 500 has once again been a consequence of ratio expansion. As earnings season draws to a close, we now expect that Q2-2016 will show another decline YoY, which would mark the fifth consecutive quarter of negative growth for the S&P 500 company, a first since the great financial crisis of 2008. The earnings recession is expected to end only at the 4th quarter, but as we can see in chart 8, expectations have a tendency to disappoint.

Waiting for growth

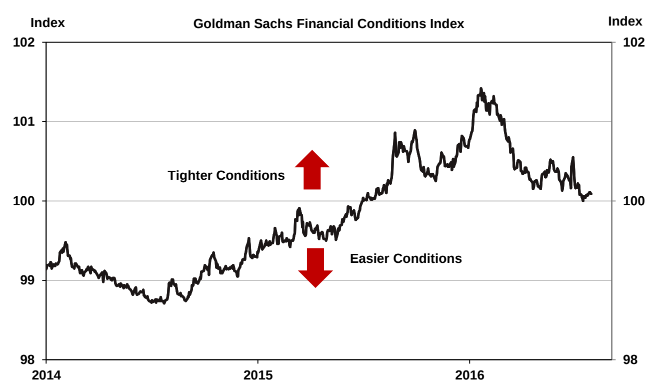


Source: Datastream

8

While the second half looks stretched valuations-wise, we believe the current economic background will eventually have a positive effect in equity returns. Even though the Fed is still trying to find the right timing to tighten its monetary policy, the domestic conditions haven't been this accommodating since August 2015 (chart 9).

Easier conditions than when the Fed last hiked rates



Source: Bloomberg

9

For Canadian equities, we think the weak Canadian dollar should help sustain earnings going forward. While there is a risk of short-term pullback due to crude oil's fundamentals, longer-term prospects continue to look good on a relative basis. However, before we suggest increasing exposure to the asset class, we would like to see energy markets have its supply-and-demand picture clear up a bit.

In conclusion, we still favour equities over their fixed-income counterparts, as we think the former have better return potential in the medium- to long-term, especially in light of the current yield levels offered by treasuries and the diminishing impact of the strong U.S. dollar on equity earnings.