INVESTING

Asset Allocation Strategy

The Trump era

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Highlights

- When taken as a whole, whether we look at Mr. Trump's fiscal, immigration, or trade policies, inflation is expected to go up eventually and the importance of the rise will be a function of the magnitude of the plans. As for GDP growth and unemployment, these will depend on how much Mr. Trump's immigration and tariffs legislation will undermine the positive push from fiscal policies.
- The U.S. economy seems to be gaining traction with positive economic number surprises which, combined with the Fed's policy divergence with other major central banks, should act as a floor for the greenback's value.
- For crude prices, the OPEC deal will generate some support as the possibilities of a supply glut become more remote. However, USD strength will act as a headwind and, as such, we still expect the range witnessed since Q2-2016 to persist for the time being.
- A stronger dollar, combined with rallying cyclicals and climbing real rates, was challenging for gold. The downside potential remains intact and, therefore, we suggest covering the long position to go back to neutral.
- The S&P500 was not spared from the extreme moves following the November 8 results as it briefly reached the overbought territory. However, we are aware that a much friendlier environment is in place for equity markets and we suggest covering the short position to go back to neutral.

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 □

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Market review

Fixed income

- U.S. 10-year Treasuries jumped 55 bps from 1.82% ahead of the election to 2.37% at month-end. Inflation expectations surged higher following Trump's spending plan in an economy already running near full capacity, strengthening the case for a Fed December rate hike.
- In Canada, yields have risen in sync with their U.S. counterparts with the 10-year bond now at 1.58%, up 38 bps from a month-earlier.

Canadian equities

- The S&P/TSX closed the month 2.2% higher following what has been a major switch toward cyclicals sectors (Financials, Industrials, Cons. Disc., I.T.) and away from defensive ones (Utilities, Cons. Staples, Telecom, Healthcare).
- Rate movements explains most of the surge in Bank and Insurance stocks, while gold stocks dragged down materials equities.

U.S. equities

- Equities focussed on the bright side of a Trump presidency as his plan to massively investment in infrastructure and cut corporate taxes pushed cyclicals significantly higher.
- Financials posted double-digit returns given expectations of better margins out of a steepening yield curve along with the prospect of lighter financial regulation.

Commodities

- Bolstered by the OPEC deal which should stabilize the offer and demand picture, crude oil prices more than compensated for the losses at the beginning of the month.
- Gold took it on the chin in November as global sentiment improved along with real rates. Copper surged 20%, thanks to prospects of massive infrastructure spending south of the border and a pick-up in Chinese demand.

Foreign exchange

- The greenback appreciated with surging treasury yields and a December rate hike now fully priced-in.
- The Canadian dollar closed almost unchanged as it closely tracked oil prices, which helped the currency resist to U.S. dollar strength.

Table 2 **Market total returns**

Asset classes	November	YTD	12 months
Cash (3-month T-bills)	0.0%	0.5%	0.5%
Bonds (FTSE/TMX Ovr. Univ.)	**-2.1%**	**2.2%**	**3.3%**
FTSE/TMX Short term	-0.5%	1.1%	1.5%
FTSE/TMX Mid term	-2.1%	2.0%	3.2%
FTSE/TMX Long term	-4.2%	3.8%	5.8%
FTSE/TMX Government	-2.4%	1.5%	2.9%
Federal	-1.9%	0.6%	1.7%
Provinces	-2.9%	2.4%	4.1%
Municipales	-2.3%	2.5%	3.9%
FTSE/TMX Corporate	-1.3%	3.9%	4.5%
AA+	-0.6%	2.2%	2.7%
A	-1.8%	3.9%	4.8%
BBB	-1.2%	5.2%	5.6%
BoAML High-Yield (USD)	-0.4%	15.2%	12.3%
Preferred shares	-0.7%	3.3%	5.6%
Canada (S&P/TSX)	**2.2%**	**19.1%**	**15.5%**
Energy	4.6%	33.6%	26.7%
Industrials	6.3%	23.6%	18.3%
Financials	5.1%	19.9%	16.1%
Materials	-4.7%	42.1%	39.0%
Utilities	-4.7%	14.2%	16.6%
Cons. Disc	2.0%	8.7%	2.6%
Cons. Staples	-3.1%	7.7%	7.6%
Healthcare	-8.5%	-77.3%	-74.0%
IT	1.9%	6.3%	7.6%
Telecom	-4.2%	12.8%	5.3%
S&P/TSX Small cap	2.0%	33.3%	31.2%
US (S&P500 / USD)	**3.7%**	**9.8%**	**8.1%**
Energy	8.4%	25.0%	12.6%
Industrials	8.8%	18.3%	15.9%
Financials	13.9%	18.2%	15.7%
Materials	6.9%	16.5%	11.7%
Utilities	-5.4%	10.8%	13.2%
Cons. Disc	4.7%	6.0%	3.0%
Cons. Staples	-4.3%	2.1%	5.1%
Healthcare	2.0%	-3.4%	-1.7%
IT	-0.3%	12.1%	9.5%
Telecom	3.6%	14.2%	16.2%
Russell 2000 (USD)	11.0%	16.4%	10.4%
World eq. (MSCI ACWI / USD)	**0.8%**	**6.1%**	**4.3%**
MSCI EAFE (USD)	-2.0%	-1.9%	-3.2%
MSCI EM (USD)	-4.6%	11.3%	8.9%
Commodities (CRB index)	**4.3%**	**12.3%**	**9.6%**
WTI oil (US$/barrel)	5.5%	32.9%	18.8%
Gold (US$/ounce)	-7.9%	10.5%	10.3%
Copper (US$/tonne)	20.1%	23.5%	26.4%
Forex (DXY - US Dollar index)	**3.1%**	**2.9%**	**1.3%**
USD per EUR	-3.2%	-2.3%	0.4%
CAD per USD	0.2%	-2.9%	0.5%

Source: Datastream 11/30/2016

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The Donald's inflation

Once again, polls were wrong and the anti-establishment votes ruled the day on November 8 as Donald Trump won the U.S. presidency. Not only that, but the GOP retained control of the House, giving the President-elect a very friendly environment to implement his agenda once he assumes power. Financial assets witnessed huge short-term moves and, in our view, they seem a bit overdone (charts 1, 2, 3), especially considering we have very little details on the real implications of the election.

While it is true some promises made during the campaign have the potential to influence markets in a material way, if implemented, the magnitude or timing of some policy decisions remains unclear. Investors will need to differentiate among tactical moves, strategic and cyclical ones. While we broached the subject in November's letter, now that the picture is clearer, we think it is time to delve into what a Trump Presidency will mean.

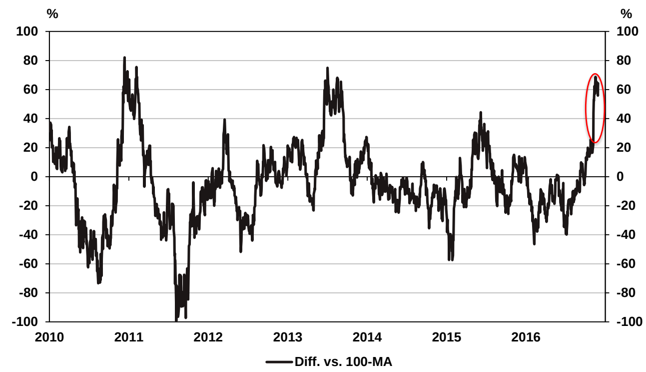
- **<u>Fiscal policy</u>**: This point is probably the one that will have the most impact down the road. Mr. Trump's approach would rely on three legs: tax reform, defense spending, and infrastructure investments.

  Tax reform would entail reducing the top marginal rate from 39% to 33%, and the corporate tax rate from 35% to 15%. This would imply a shortfall of around $400 bn in revenue. The second element, defense spending, would rely upon an end to spending cuts in defense which amount to $40 bn per year. This expense likely would be offset by domestic spending cuts in other areas.

  The promise getting the most headlines is infrastructure spending. The projects would probably include some form of private investments, which would then generate revenues from different sources such as fees or tolls. The government could also help spur those investments with different tax credits. For now, it seems that $500 bn to $600 bn is earmarked, but we have very little detail on the implementation or specific projects being considered.

  There is no doubt the impact of these policies on U.S. growth will be positive. However, *how* important the impact will be is hard to assess, because the amounts for infrastructure projects or final tax cut rates are still subject to change and timing of implementation will also have an effect. Tax reform has the potential to kick-in much sooner than infrastructure (which could take more than a year before investments boost the domestic economy). Inflation should also tick higher via wage appreciation as the economy is already operating close to full employment.

10-year yields: Inflation and steepening of the curve



Source: Bloomberg

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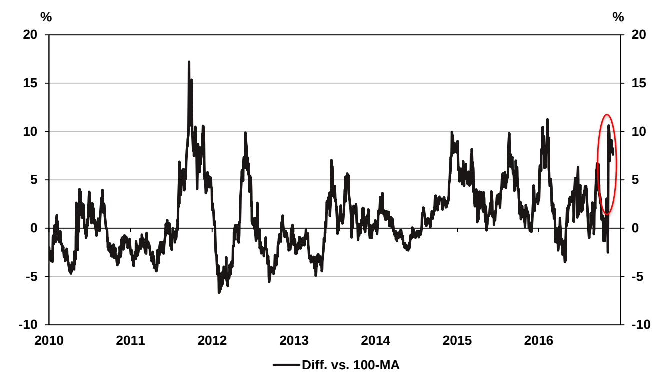
Mexican Peso: suffering from potential trade wars



Source: Bloomberg

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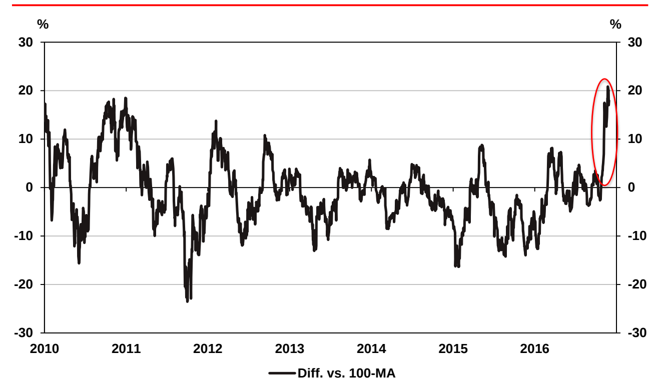
Copper: Improved prospects from infrastructure projects



Source: Bloomberg

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- **<u>Immigration</u>:** While "build the wall" or mass deportations were promises that got attention, the complexity of such endeavours greatly diminishes the chance of them being fully implemented. However, we can assume that immigration will slow down in the coming years via policies aimed at restricting the issuance of work visas and more stringent verifications of work eligibility in the U.S. being applied for any worker (e-verify) which would force some illegal immigrants to leave as they wouldn't be able to find work.

  The potential impact of those policies range from mild to very adverse for the U.S. economy depending on how strongly the government will act. The more immigration is curtailed, the higher the chances labour markets will overheat due to shortage. This, in turn, causes inflation and aggressive monetary tightening by the Fed, which would then put the U.S. economy at risk of slowing down.

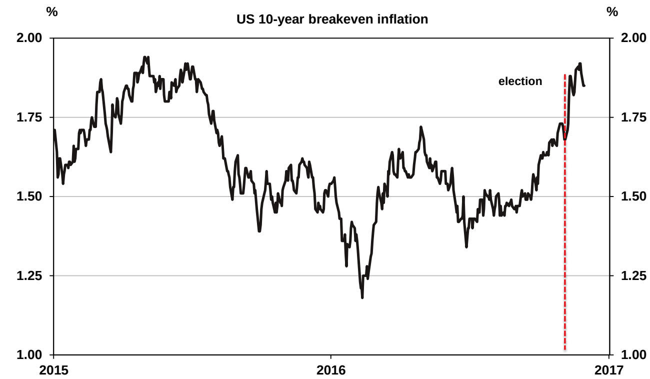
- **<u>Trade policy</u>:** President-elect Trump already ruled out participation in the Trans-Pacific Partnership and has consistently insisted on revisiting the NAFTA agreement during the campaign, imposing tariffs of 35% on imports from Mexico and 45% on China were also previously suggested by Mr. Trump.

  Under any scenario where tariffs are imposed, imports usually diminish. Inflation quickly follows suit, which then translates to lower consumption as erosion of real income sets in. The damage done will also depend on whether countries targeted by these actions will retaliate. If there is some form of reciprocal tariffs imposed on the U.S., damage on its domestic economy will be greatly compounded.

  Two points to consider will be corporate America's reaction to the plan, and the pressure it will put on the President to limit the scope of tariffs. Most multi-nationals greatly profited from globalization, and trade barriers will adversely affect their operational supply chains (which would then translate to lower earnings down the road). Conceptually, trade barriers also run counter to the GOP's philosophy promoting free markets. However, the President-elect continually flouted the party's orthodoxy during the campaign, so there is uncertainty about how much sway Republicans will have in influencing Mr. Trump.

When taken as a whole, whether we look at fiscal, immigration, or trade policies, inflation is expected to go up eventually and the importance of the rise will be a function of the magnitude of the plans (chart 4). As for GDP growth and unemployment, these will depend on how much Mr. Trump's immigration and tariffs legislation will undermine the positive push from fiscal policies.

Mr. Trump's plan is adding to an already increasing inflation



Source: Datastream
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The Fed's reaction to those changes will also be a major point of analysis going forward, as inflationary pressures were already mounting and the President-elect will be adding fuel to the fire. The projections at the next FOMC meeting on December 14 will give us important clues as to what the Fed expects going forward (a point we will discuss in the next section).

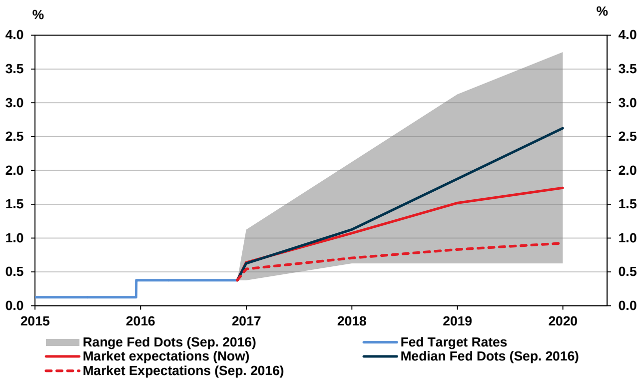
Fixed income: A shock, now what?

Yield reaction to the election outcome has been brutal and marked the end of complacency in fixed-income products. However, when we take a longer view, we notice that we have just rebounded to levels witnessed only a year ago. A hike is now a certainty at the next FOMC meeting and market expectations are showing a convergence with the Fed regarding the path of monetary policy tightening going forward (chart 5, next page).

The base-case scenario on the short-term horizon should not change much for the Central Bank, and Chair Yellen recently acknowledged as much in testimony to congress saying that it is still too soon to predict the economic effects of the election and there's still a great deal of uncertainty. She also noted that the members would be watching the decisions that Congress makes and updating their economic outlook as the policy outlook becomes clearer.

As we discussed previously, the bulk of the fiscal policies put forth by Mr. Trump could take more than a year to materialize. The subsequent effects on the economy would take even more time and the U.S. yield curve has steepened to reflect that outcome. In light of the tightening labour markets, the FOMC will be keeping a close eye on wage costs and will try to judge the appropriate approach about its monetary policy, in order to limit the probabilities of having to slam on the brakes on the economy should inflation run out of control.

Markets and the Fed agree until 2018



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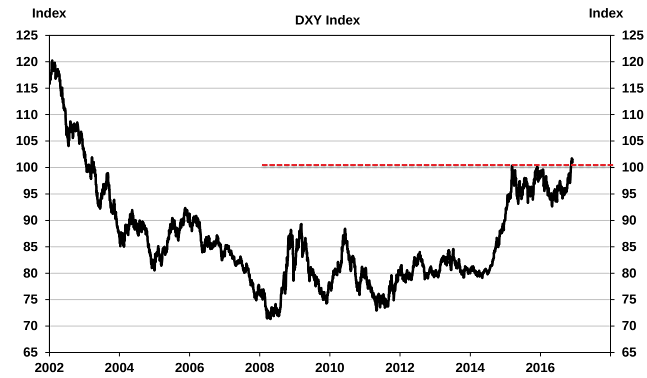
The highs recently broken should act as a floor



Source: Datastream
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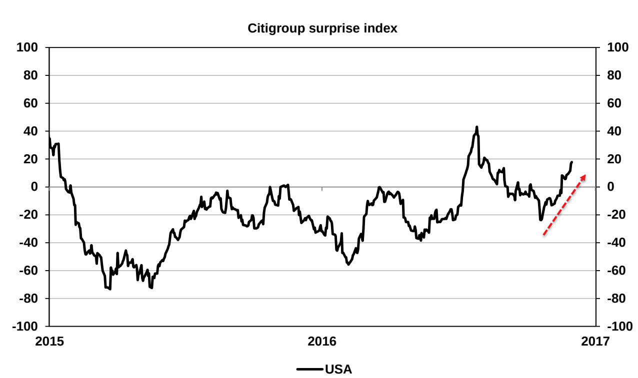
Until the dust settles in fixed-income products and we get a clearer picture concerning the fiscal policies from the new U.S. administration, we suggest an underweight as well as a defensive position duration-wise.

Currencies: USD strength to persist

The election results added to the greenback's strength which, on the short-term horizon, is in overbought territory. However, the U.S. economy seems to be gaining traction with positive economic number surprises (chart 6) which, combined with the Fed's policy divergence with other major central banks, should act as a floor (chart 7).

This will act as a headwind for the loonie as the BoC's dovish stance is likely to continue for a while until the economy is back on track. These forces have the potential to overshadow any support coming from commodity price strength and the Canadian dollar will likely remain under pressure. Consequently, we suggest gradually removing the currency hedge.

Closing 2016 by beating expectations?



Source: Datastream
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Commodities: OPEC deal will put a floor on prices

The OPEC members finally agreed to cap the cartel's output on Nov. 30 in Vienna. The aim of deal is to ensure the world's surplus/deficit is roughly balanced for the first half of 2017 until demand growth finally reaches the "pre-cut" supply figures during the second half of the year (see table 3).

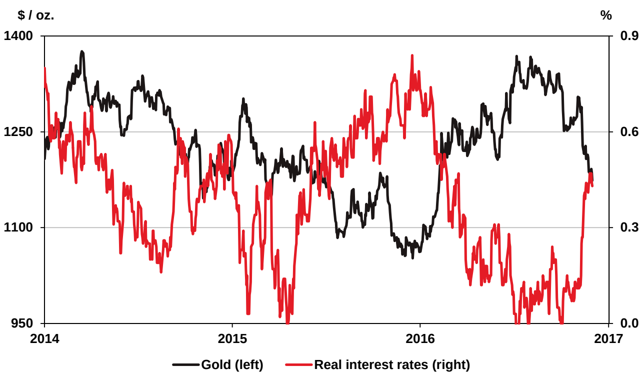
For crude prices, this deal will act as a floor as the possibilities of a supply glut become more remote. However, USD strength will act as a headwind and, as such, we still expect the range witnessed since Q2-2016 to persist for the time being. Should prices break out on the upside, we expect producers unconstrained by the deal will ramp up their output to take advantage of better profit margins. We should not forget that OPEC members are notorious for cheating on their cap and producer a little more than what was initially agreed upon.

Table 3: **Crude 2017 supply/demand picture, (Mb/d.)**

Pre-cut expected supply	97.9
Projected demand	97.5
Pre-cut surplus/deficit	**0.4**
Cuts	
Saudi Arabia	-0.5
Iraq	-0.2
UAE	-0.1
Kuwait	-0.1
Russia (non-OPEC)	-0.3
Other (non-OPEC)	-0.3
Post-cut surplus/Deficit	**-1.1**
Producer response to increased prices & agreement cheating	**+ ?**

A stronger dollar, combined with rallying cyclicals and climbing real rates, was challenging for gold (chart 8). The downside potential remains intact and, therefore, we suggest covering the long position to go back to neutral.

Gold can't resist to the real rates surge



Source: Datastream
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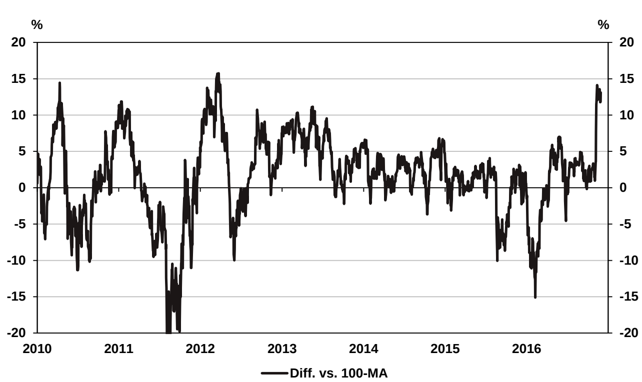
Equities: Conflicting forces

The election results brought a wave of optimism in U.S. equity markets with investors hoping that tax breaks would help financial ratios and earnings for the S&P500, while infrastructure projects would help boost both economic growth and equity returns in its wake. Meanwhile, financials also benefitted from the prospect of reduced regulation and the steepening of the yield curve (chart 9).

However, we think the rebound is premature, as any projects will take a while to materialize, and we still have few details on how the plan will pan out. The bottom line for multinationals could also suffer from the U.S. dollar strengthening, which will act as a drag on foreign revenues, denominated in USD. They are also exposed to risks emerging from abroad (see box 1, next page) and wage inflation picking up materially, especially in light of stimulative fiscal policy in a tight labour market.

Financials: yield moves improve earnings prospects



Source: Datastream
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The S&P500 was not spared from the extreme moves following the November 8th results as it briefly reached the overbought territory. However, we are aware that a much friendlier environment is in place for equity markets and we suggest covering the short position to go back to neutral.

The S&P/TSX benefitted from its two heavyweights given increased optimism toward financials earnings and a U.S. administration favouring fossil fuels. However, in our view the valuation picture still justifies a neutral stance on Canadian equities. Indeed, market expectations of earnings growth currently priced-in seems high in light of the current economic environment, and the sentiment toward trade south-of-the-border makes an export-led growth scenario unlikely or fragile for now. We will keep an eye on the economic rebound in the country and should it accelerate faster than expected, we would consider an overweight for the asset class.

Box 1: Italian referendum

Referendum details: On December 4, Italians will be called upon to vote on amending their constitution aiming to reform the different powers and legislative process of Parliament.

Polls: The "no" side is currently in the lead at 52%, but there are a lot of undecided voters who could sway the results. However, we must note that other recent elections showed polls failing to represent the anti-establishment support, which could be interpreted as the "no" currently being under-reported in the polls.

Why the outcome matters: Prime Minister Renzi has tied his political future to the vote and said he would resign should the "no" prevail, which would generate some uncertainty about snap elections being called or a new government to be formed. Elections would become the worst-case scenario as the current centre-left Democratic Party is only leading the Eurosceptic/populist/protectionist Five Star Movement (M5S) by a narrow margin. Therefore, concerns are heightened about a potential election in light of the recent populist victories across the world.

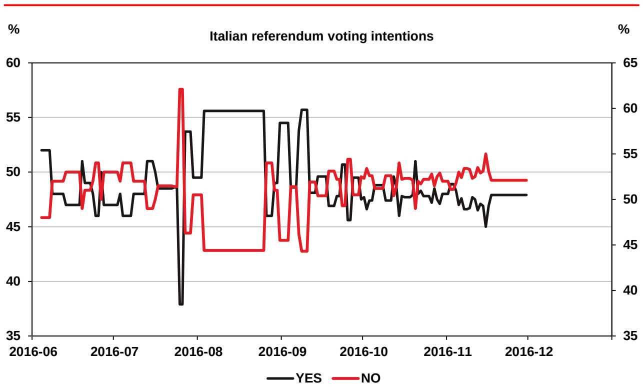
Base-case scenario is the "no" wins: Elections are not a sure bet. It is expected that the Prime Minister will resign, but the party could stay in power with another market-friendly figure taking the lead as the Democratic Party would still have the population's support. This would probably push elections toward Spring of 2018 and the natural end of the legislature cycle.

The M5S and EU support in Italy: The country is still pro-Europe, as polls indicate that more than half of the population want to stay in the EU. So, even if a snap election was called, an "Italeave" is still far from a certainty should the party win the election. However, we still have Brexit in the back of our minds where the "remain" option was enjoying a similar lead several months before the "Brexit" vote.

Potential financial markets reaction to the outcome: As the "no" is currently in the lead, this outcome is probably priced in. We would still expect some volatility until the dust settles and it becomes clear that elections would not be held. However, should the "no" option prevail with a larger-than-expected margin, this could be interpreted as putting the next election in a much more dangerous zone than previously thought, and markets would need to reassess the possibility of an "Italeave." Moreover, this referendum outcome will not unfold in a vacuum, as other Euro countries are keeping close tabs on the populist trend and have other elections in 2018 (Netherlands, France, Germany).

Conclusion: We still believe the chances of an adverse event are small for now. The path for an Italian exit from the EU seems very narrow and pretty remote. If anything, the Brexit and U.S. Presidential elections should serve as lessons for not becoming complacent. Italy's GDP is roughly 11% of EU's total, setting it as the Union's 4th biggest contributing economy, which means any potential pitfall would greatly impact the Union.

Is the "NO" vote underrepresented?



Source: Bloomberg
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