November 1, 2016

INVESTING

Asset Allocation Strategy

Vote of non-confidence

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Editor's note

As you can see in Table 1, there have been a lot of changes in our asset allocation in October, particularly the underweight in equities which may appear to some as a major asset-mix call. However, most of these shifts are tactical, and do not represent a long-term view on our part. We took this position to protect the capital in light of some risks (explained in this letter), and are ready to get back to neutral weightings, or even overweight, when the situation is constructive for returns.

Highlights

- For the US elections, the big picture is that Clinton would be the status-quo candidate while Trump would represent a clear break with the traditional approach to government. As the polls are predicting a Clinton victory, we think the outcome is priced-in for the stock market.
- In gold, we think the underlying fundamental demand, or technical levels, will trump further speculative selling going forward.
- BoC Governor Poloz struck a very dovish tone by mentioning that adding more monetary stimulus to speed up the economic recovery was actively discussed. This monetary policy divergence with the Fed, added to the potential of lower energy prices, makes the case for a weaker loonie and we suggest gradually removing the currency hedge to gain exposure to U.S. dollar strength.
- In equities, increasing yields and U.S. dollar doesn't bode well for return prospects. We are in the midst of earnings season and it's projected that the quarter will show negative or very little growth on a year-over-year basis for the 6th consecutive period. Added to expensive valuations, the U.S. election will also be a source of volatility and have potential pitfalls. Consequently we suggest an underweight in U.S. equities for the time being, but if they were to experience a selloff, we will quickly bring our position 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 ▨

Market review

Fixed income

- U.S. 10-year bond yields showed strength throughout October, closing at 1.83% (up 0.24%).
- On the Canadian side, treasuries of the same tenor followed their southern neighbors (closed at 1.20%, up 0.19%), but yield appreciation was somewhat mitigated by BoC Governor Poloz's dovish comments.

Canadian equities

- The S&P/TSX's heavy weighting in financials and energy helped the index squeeze out positive performance for the month. Banks took advantage of higher bond yields while higher-margin cost energy producers felt relief from crude price levels.
- Gold producers felt the brunt of the precious metal's rout at the beginning of the month.

U.S. equities

- Better potential earning margins from the yield increase benefitted financials, which was the only sector recording a significant positive performance for the month.
- As expected, such a yield environment is very detrimental for Defensives, which lost on average 3.2% in October.

Commodities

- For crude oil, the OPEC deal, added to unseasonal inventory draws helped perpetuate September's momentum in the first few weeks of the month. But, continued dollar strength and news that the deal is far from a sure thing reversed the trend.
- Gold suffered from Jeffrey Lacker's hawkish comments at the start of the October, then traded on a slow and tight uptrend afterwards.

Foreign exchange

- Policy divergence between major central banks and the Fed, pushed the USD higher.
- The Canadian dollar resisted fairly well to greenback strength and Mr. Poloz's dovish comments.

Table 2 **Market total returns**

Asset classes	October	YTD	12 months
Cash (3-month T-bills)	0.1%	0.4%	0.5%
Bonds (FTSE/TMX Ovr. Univ.)	**-0.9%**	**4.3%**	**5.6%**
FTSE/TMX Short term	0.0%	1.6%	2.1%
FTSE/TMX Mid term	-0.7%	4.2%	5.3%
FTSE/TMX Long term	-2.3%	8.3%	10.8%
FTSE/TMX Government	-1.1%	4.0%	5.3%
Federal	-0.8%	2.6%	3.6%
Provinces	-1.4%	5.4%	7.1%
Municipales	-1.1%	4.9%	6.3%
FTSE/TMX Corporate	-0.4%	5.2%	6.3%
AA+	0.0%	2.8%	3.6%
A	-0.9%	5.8%	7.3%
BBB	-0.3%	6.5%	7.5%
BoAML High-Yield (USD)	0.3%	15.7%	10.2%
Preferred shares	2.3%	3.9%	5.0%
Canada (S&P/TSX)	**0.6%**	**16.5%**	**12.7%**
Energy	0.9%	27.7%	16.7%
Industrials	-0.3%	16.3%	12.4%
Financials	2.6%	14.2%	11.6%
Materials	-0.9%	49.2%	44.3%
Utilities	1.5%	19.9%	20.3%
Cons. Disc	-2.2%	6.6%	-2.1%
Cons. Staples	1.9%	11.2%	14.3%
Healthcare	-17.7%	-75.2%	-71.1%
IT	-1.3%	4.3%	13.6%
Telecom	-0.2%	17.8%	10.0%
S&P/TSX Small cap	-2.6%	30.7%	26.5%
US (S&P500 / USD)	**-1.8%**	**5.9%**	**4.5%**
Energy	-2.9%	15.3%	3.6%
Industrials	-2.0%	8.6%	7.5%
Financials	2.3%	3.7%	3.5%
Materials	-2.1%	9.1%	5.4%
Utilities	0.9%	17.1%	17.1%
Cons. Disc	-2.3%	1.2%	-1.8%
Cons. Staples	-0.8%	6.7%	8.6%
Healthcare	-6.5%	-5.2%	-4.0%
IT	-0.1%	12.4%	10.8%
Telecom	-6.5%	10.2%	10.7%
Russell 2000 (USD)	-4.8%	4.9%	2.5%
World eq. (MSCI ACWI / USD)	**-1.7%**	**5.3%**	**2.6%**
MSCI EAFE (USD)	-2.0%	0.1%	-2.7%
MSCI EM (USD)	0.2%	16.6%	9.7%
Commodities (CRB index)	**0.2%**	**7.7%**	**2.1%**
WTI oil (US$/barrel)	-2.8%	26.0%	1.0%
Gold (US$/ounce)	-3.6%	19.9%	11.6%
Copper (US$/tonne)	-0.1%	2.9%	-5.6%
Forex (DXY - US Dollar index)	**3.1%**	**-0.2%**	**1.5%**
USD per EUR	-2.5%	0.9%	-0.8%
CAD per USD	2.1%	-3.1%	2.5%

Source: Datastream 10/31/2016

U.S. Elections: Nearing the finish line

As we approach November 8, there's an increasing focus on the aftermath of the results and what it will mean for equities and the U.S. economic situation. As we stand now, Hillary Clinton seemed poised to win the election by a fairly large margin but a surprise announcement by FBI Director James Comey regarding Clinton's e-mail server has the potential to materially cut that lead. We don't believe we'll face another surprise of the "Brexit" type, but we think assessing the risks or consequences of a Clinton vs. Trump win helps understanding what's at stake.

- **Impact on equities:**
  (Clinton win - neutral; Trump win - negative)
  As the polls are predicting a Clinton victory, we think the outcome is priced-in. If Trump were to cause a surprise, then we would expect equities to sell-off, as this would usher an era of uncertainty and volatility would dramatically increase shortly after the outcome. Investors would need to reassess how free-trade agreements will be impacted, and how some policies or promises made during the campaign would affect potential earnings.

  Both candidates have made the case for repatriation via a tax holiday for earnings overseas to pay for a fiscal stimulus plan. This would undoubtedly be positive for equity markets, especially multinationals who have a large portion of earnings generated abroad.

  As for the impact for individual sectors, some industries stand to benefit from a Clinton win, while others would be facing headwinds (table 3).

- **Impact on business investments:**
  (Clinton win - positive; Trump win - negative)
  In September's letter, we argued that business investments were not only a consequence of crude oil's downturn but also political uncertainty. A Clinton win would assuage those fears as markets like predictability. It's expected that a Clinton presidency would represent a continuation of the policies set by the previous administration. By contrast, a Trump victory would just increase uncertainty, especially regarding some protectionist promises which would certainly push corporations to take a defensive stance and wait for more clarity.

- **Impact on inflation:**
  (Clinton win - positive; Trump win - positive)
  Both candidates have plans to invest in infrastructure. Clinton has promised to spend up to $275 billion over the next five years, financed by the corporate tax reform we discussed previously. She also wants to set up a National Infrastructure Bank to spur private investments. While no

Table 3: **Impact of elections on sectors**

Sector	Clinton win	Trump win
Financials	**Negative** Is more at risk of implementing further regulation on financial institutions which would diminish their earnings potential.	**Positive** Would be inclined to follow GOP party's philosophy of limiting rules and use a more laissez-faire approach. Vouched to change or repeal Dodd-Frank.
Healthcare	**Mixed** Biotech: Promised to pass laws reining in the costs of drugs. Hospitals: Expansion of Obamacare which would be a tailwind to the subsector.	**Positive** Biotech: Opposed to regulation of the industry. Hospitals: Wants to repeal the ACA, which would adversely affect hospital service providers.
Energy	**Mixed** Crude/NG/Coal: Opposition to coal mining as well as offshore drilling which will prove challenging. Green energy: In favour of tax incentives for solar and wind power.	**Mixed** Crude/NG/Coal: Would be inclined to follow GOP party's philosophy to repeal or reduce regulation limiting exploration and exploitation. In favour of Keystone Pipeline. Green energy: No clear support, more fossil fuel access reduces the competitiveness of green energy.
Materials/ Industrials	**Positive** Clinton promised to spend up to $275 B over the next 5 years on infrastructure projects. Also vouched to set up a National Infrastructure Bank.	**Positive** Trumps position is unclear but he was in favour of infrastructure spending and would double Clinton's total.

specifics were given, Trump said he wanted to double Clinton's total, if elected.

Minimum wage increases are also on the table. Now standing at $7.50/hour, Clinton wants to increase it to $12/hour. While Trump has been unclear on the level, he has expressed some support for $10/hour, although it's not an official campaign position.

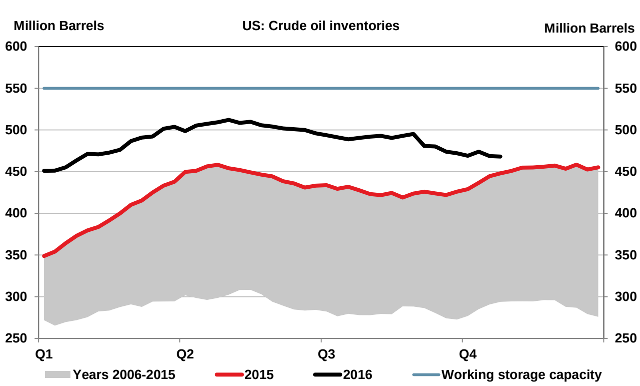
The big picture is that Clinton would be the status-quo candidate while Trump would represent a clear break with the traditional approach to government. While the presidential election is currently making headlines, the Senate and House of Representatives' ballots are also very important in setting domestic policy as they can stop or hinder major presidential initiatives. Polling still seems to favor Clinton, but only the Senate is likely to turn to Democratic control and the House is expected to remain Republican. This is the same situation as President Obama had to contend with from 2011 to 2015.

Commodities: Golden opportunities

The favourable environment we witnessed in crude oil since the end of the summer seems to be drawing to a close. The recent run-up in prices has been due to a combination of three factors that we think are transitory in nature and will eventually reverse course:

1. **Imports**: Usually the Fall/Winter season is a period when inventories are supposed to build as demand coming from the driving season winds down. U.S. imports of crude oil have been hovering around 2016 lows and created unseasonal draws in inventory reports which offered some relief to inventory capacity (chart 1). We think this may have been due to the North Sea production centres which underwent some maintenance. As such, we think those low import numbers should revert back to normal in the coming weeks, once those fields are back online.

Unseasonal draws gives some capacity breathing room



Source: Datastream
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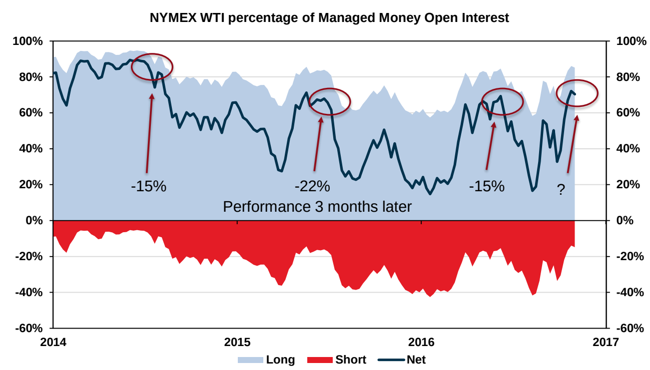
2. **OPEC deal**: The OPEC deal capping future production levels created an implicit floor on prices, and the prospect of earlier-than-expected rebalancing of the supply-and-demand picture. The gap between the announcement itself and implementation is growing with each headline. Iraq is now openly advocating for an exemption because it feels its production has been unfairly constrained by the continuous wars within its territory. If the country does manage to gain an exemption, the cartel would then be allowing exemptions to 4 out of its 14 members, and for a third of OPEC's output --- hardly motivation for other members to push for a strong agreement.
3. **Speculation**: Once again, speculative length has reached levels where a correction seems more and more probable. We've seen that situation before in May 2016 (chart 2), right before WTI dropped by $10.

Once again, speculative extremes can drag prices along



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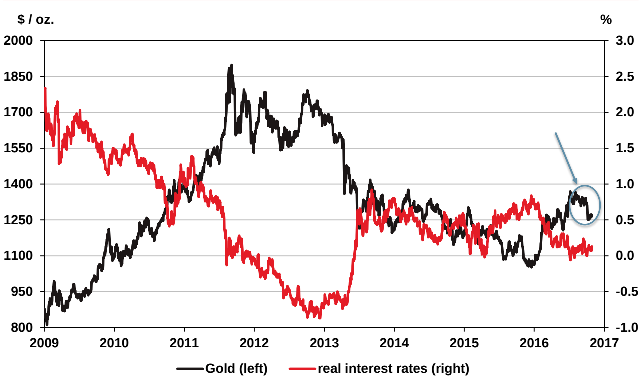
Those factors, added to the $50 resistance which seems hard to break materially on the upside, makes us think that prices appear toppish at best, and that risks of a correction are mounting.

The reverse is happening for gold prices which were supposedly victim of Fed official Jeffrey Lacker's hawkish comments urging the Central Bank to act sooner rather than later to contain inflation. By digging a little deeper we find evidence that there's more to it than just a headline and we think a rebound is in the cards. Consequently, we suggest having some exposure to the precious metal because of the following reasons:

1. **Inflation**: While we expect energy prices to weaken, let's not forget that WTI was sub-$30 in Q1-2016, and the year-over-year performance will eventually be felt in annualized CPI figures.

2. **Real rates**: Gold is usually correlated to real rates, but we witnessed a breakup of that relationship at the beginning of the month which makes us think that the selloff may have been overdone (chart 3 and 4). Even with the Fed expected to eventually hike over the next couple of meetings and with a couple of members pushing towards a much more hawkish stance, the committee seems inclined to let the economy "run a little hot," which makes the case for downward pressure on real rates and higher gold prices going forward.
3. **China demand**: The Yuan's continued depreciation has increased the appetite of Chinese investors for the precious metal as a store of value (chart 5) and a way to escape capital controls. We think this trend will continue for a while. The incredible rally in property values also worries the Chinese authorities who are moving towards implementing some form of regulation to rein in speculation and price increases. As such, gold represents an attractive alternative to divert investments out of real estate.

A strange disconnect in the real-rates / gold pair…



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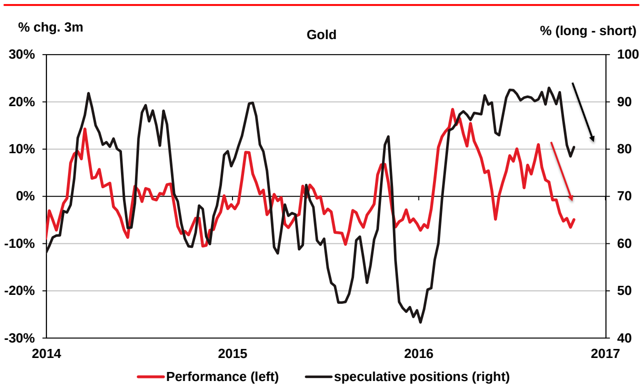
… probably due to a speculative reversal



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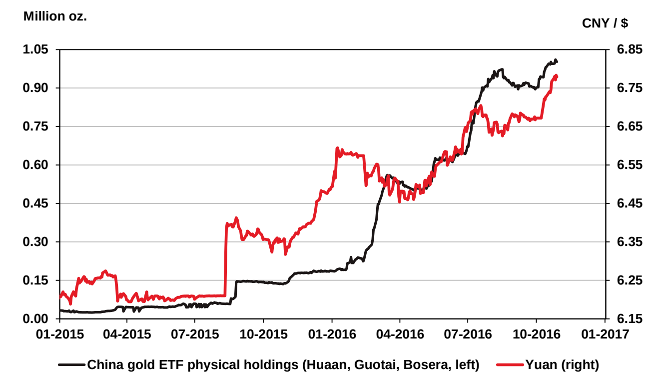
4. **Technicals**: Prices broke above the 200-day moving average (chart 6) which will now act as a support and makes the case for further appreciation.

Even though futures' net positioning is less skewed toward length than in previous weeks and has somewhat reverted towards the mean, it's still considered high by historical standards. However, we think the underlying fundamental demand, or technical levels stemming from the points enumerated above, will trump further speculative selling going forward.

Appetite for diversification is growing in China



Source: Datastream
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The moving-average should act as a support

Source: Datastream
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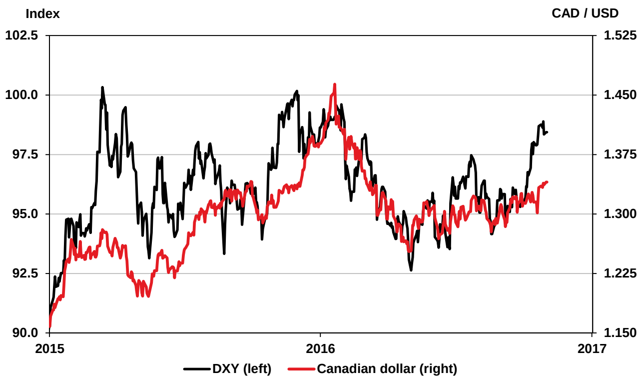
Currencies: Time to remove the Canadian dollar hedge

The greenback has been on a big uptrend since the beginning of October but, bolstered by crude oil strength, the Canadian dollar has shown some resilience compared to other currencies (chart 7, next page). However, BoC Governor Poloz struck a very dovish tone in the press conference following October's rate decision by mentioning that adding more monetary stimulus to speed up the economic recovery was actively discussed. This monetary policy divergence with the Fed, added to the potential of lower energy prices, makes the case for a weaker loonie and we suggest gradually removing the currency hedge to gain exposure to U.S. dollar strength (chart 8).

Crude helped the loonie resist to US dollar strength…



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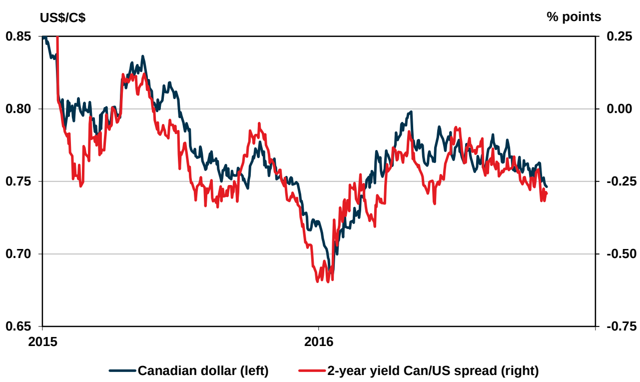
… but monetary policy still drives the show



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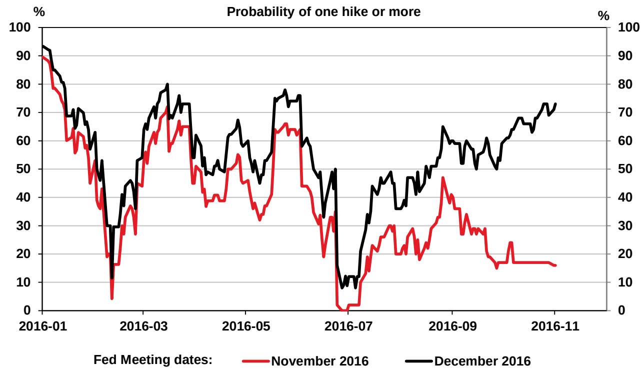
Fixed income: Still some space for yields to go higher

Yields have rebounded since the beginning of the month and are now well off the lows reached in July. However, they are still down on a year-over-year basis and we believe there's still some space left for further appreciation. The odds of a hike by the end of the year are still hovering around 70% (chart 9) which means we are probably repeating the December 2015 scenario where the Fed signaled a "dovish hike" where the statement tied to monetary tightening was very accommodating. Yields increased in anticipation right up to the meeting date to sell-off afterwards.

A "dovish hike" in December?



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We therefore continue to suggest an underweight in fixed-income products as well as a defensive position duration-wise. We do not expect any major economic downturn in the coming months. So, we think being more aggressive on the credit side will give investors better return prospects, as this strategy has the benefit of offering higher yields while mitigating the impact of a potential hike.

One way to invest in longer-duration bonds would be through Treasury Inflation-Protected securities (TIPS). As the transitory effects of low energy price levels on inflation start to fade, TIPS will provide some form of protection against such a scenario, and levels are still attractive for the product.

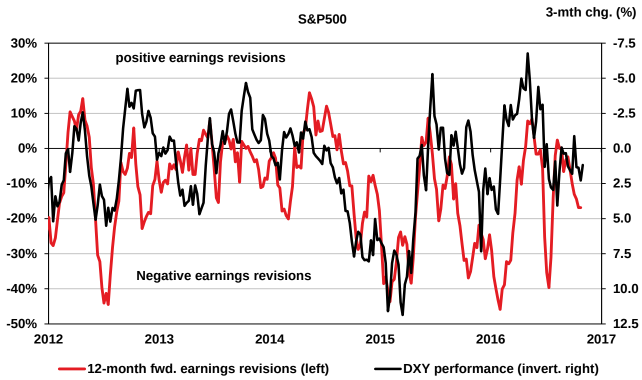
In the "Commodities" section, we suggested investing in gold. In our view, TIPS and the precious metal have some overlapping themes regarding inflation, but we chose gold mainly because it's fiscally more advantageous and less exposed to yield increases.

Equities: Too many headwinds for comfort

Increasing yields and U.S. dollar doesn't bode well for return prospects (chart 10). We are in the midst of earnings season and it's projected that the quarter will show negative or very little growth on a year-over-year basis for the 6th consecutive period. This lack of momentum is hardly constructive, especially when multiples are trading well above historical norms.

Added to expensive valuations, the U.S. election will also be a source of volatility and have potential pitfalls --- not only if Trump is elected, but also if the Democrats win a "wave election" which would mean more aggressive legislation that would be detrimental to equity markets. Even if a Democratic wave seems less and less likely, the situation is still fluid and, in

US dollar strength is a drag on earnings potential



Source: Datastream
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light of those risks, we believe taking a tactical defensive position to protect capital is a sensible strategy.

We suggest an underweight in U.S. equities for the time being, but if they were to experience a selloff, we will quickly bring our position back to neutral.

The reason we are maintaining our neutral stance on their Canadian counterpart (in spite of our energy views) is because we think the weaker loonie will help exports, and the BoC's dovish stance added to the governmental fiscal stimulus plans will support the asset class.