INVESTING

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Asset Allocation Strategy

Fed: running around in circles

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Highlights

- The influence of market reactions pushing the Fed to reassess its policy is hard to break, and the Central Bank needs the perfect combination of economic strength, job momentum, global risk containment, and strong enough inflation numbers to overpower any factors suggesting a delay.
- However, a window of opportunity is starting to open up, especially in light of Fed Chair Yellen's speech in Jackson Hole on August 26 where she said that employment numbers will remain the key data point going forward. The odds of a rate increase are now steadily increasing and good September 2 employment numbers would greatly accelerate the schedule of monetary tightening, and put the next meeting "live".
- In light of expectations regarding the US monetary policy, we suggest investing in shorter duration bonds. However, one way to invest in longer durations would be through Treasury Inflation-Protected securities (TIPS). TIPS have the potential to provide some form of protection against the possibility of rising rates because the underlying economic reason for such a scenario would be an increasing CPI.
- As we expect the FOMC to act this year, the early cyclicals, especially financials, would be poised to take the lead performance-wise once the Fed pulls the trigger, as rising interest rates boost profit margins for banks and insurance companies.
- We believe better opportunities lie ahead in equity markets as valuations are not cheap. As a consequence, we suggest keeping some liquidity on hand to invest when they present themselves.

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

- Slow and deliberate appreciation for the yield on U.S. 10-year notes (+0.10% to close at 1.57%) increased throughout the month as the probabilities of a hike in September looms. Their Canadian counterparts were directionless, settling into a tight range between 1.0% and 1.1%.
- High-yield spreads are continuing to tighten, improving the asset class's stellar performance from the beginning of the year.

Canadian equities

- Gold equities dragged the materials and S&P/TSX index down in what otherwise would have been a very solid month for Canadian equities.
- Crude oil's good performance helped the energy sector post 2.6% for the month.

U.S. equities

- The perspective of rate hikes negatively impacted the defensives (Healthcare – 3.3%, Telecom -5.7%, Utilities -5.6% and cons. staples –0.5%) which represent a third of the S&P500's market value.
- Howerver, financials benefitted from increased odds of a rate increase and were the index's best performing sector for the month.

Commodities

- The prospect of OPEC talks concerning an agreement to freeze crude oil production to a certain level helped the product shoot up 7.5% for August.
- The commodity also benefitted from a "short squeeze" as speculators were too concentrated on the short side and the news of a production freeze triggered a rush to neutralize their positions.
- The possibility of the Fed acting earlier than previously thought impacted gold as real rates have a potential to increase.

Foreign exchange

- The greenback appreciated after the likelihood of a hike increased materially to close out the month up 0.5%.
- The loonie's disconnect with crude continued as the currency barely reacted to crude oil's increase for the month.

Table 2 Market total returns

Asset classes	August	YTD	2015
Cash (3-month T-bills)	0.0%	0.3%	0.6%
Bonds (FTSE/TMX Ovr. Univ.)	**0.1%**	**5.0%**	**3.5%**
FTSE/TMX Short term	0.1%	1.3%	2.6%
FTSE/TMX Mid term	0.0%	4.5%	4.9%
FTSE/TMX Long term	0.2%	10.7%	3.8%
FTSE/TMX Government	0.0%	4.9%	3.8%
Federal	0.1%	3.3%	3.7%
Provinces	-0.2%	6.6%	4.1%
Municipales	-0.2%	5.7%	3.2%
FTSE/TMX Corporate	0.5%	5.3%	2.7%
AA+	0.2%	2.5%	3.0%
A	0.7%	6.4%	2.6%
BBB	0.5%	6.2%	2.5%
BoAML High-Yield (USD)	2.2%	14.6%	-4.6%
Preferred shares	1.1%	1.7%	-14.9%
Canada (S&P/TSX)	**0.3%**	**14.4%**	**-8.3%**
Energy	2.6%	21.8%	-22.9%
Industrials	2.9%	16.7%	-11.1%
Financials	1.7%	10.6%	-1.7%
Materials	-9.9%	46.8%	-21.0%
Utilities	-2.8%	17.4%	-3.5%
Cons. Disc	1.9%	7.7%	-1.5%
Cons. Staples	4.9%	13.4%	12.4%
Healthcare	13.9%	-66.5%	-15.6%
IT	1.5%	4.5%	15.6%
Telecom	-2.0%	17.6%	3.6%
S&P/TSX Small cap	-3.5%	30.2%	-13.3%
US (S&P500 / USD)	**0.1%**	**7.8%**	**1.4%**
Energy	1.2%	15.2%	-21.1%
Industrials	0.8%	11.0%	-2.5%
Financials	3.8%	4.2%	-1.5%
Materials	-0.1%	12.9%	-8.4%
Utilities	-5.6%	15.7%	-4.8%
Cons. Disc	-1.2%	4.0%	10.1%
Cons. Staples	-0.5%	9.1%	6.6%
Healthcare	-3.3%	1.9%	6.9%
IT	2.1%	9.8%	5.9%
Telecom	-5.7%	19.0%	3.4%
Russell 2000 (USD)	1.6%	9.2%	-5.7%
World eq. (MSCI ACWI / USD)	**0.4%**	**6.4%**	**-1.8%**
MSCI EAFE (USD)	0.1%	0.9%	-0.4%
MSCI EM (USD)	2.5%	14.8%	-14.6%
Commodities (CRB index)	**-1.3%**	**7.5%**	**-14.4%**
WTI oil (US$/barrel)	7.5%	20.2%	-30.9%
Gold (US$/ounce)	-3.1%	23.1%	-10.4%
Copper (US$/tonne)	-6.3%	-2.1%	-26.1%
Forex (DXY - US Dollar index)	**0.5%**	**-2.6%**	**9.3%**
USD per EUR	-0.4%	2.5%	-10.2%
CAD per USD	0.6%	-5.3%	19.1%

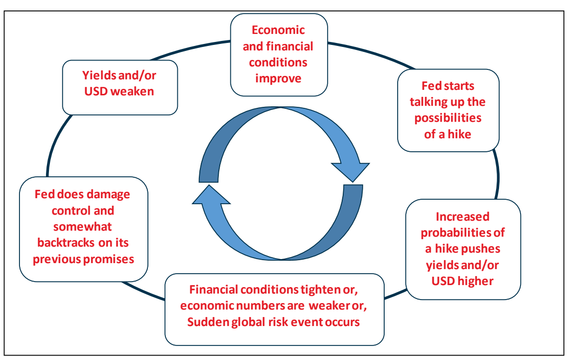
Source: Datastream 08/31/2016

The Fed and the vicious circle of uncertainty

The FOMC is currently the only major Central Bank trying to reduce its monetary policy accommodation. This situation could pose a problem as policy divergence can amplify the effects of a hike via U.S. dollar appreciation, or pre-emptively tighten financial conditions before the Fed even has a chance to act. There's also the off-chance of a surprise event on the global stage that could derail even the best laid plans. The Brexit of June 2016 was a perfect example of such a scenario, as the Fed was turning decidedly hawkish by indicating that "most members thought a hike in June was appropriate" just a few weeks before the referendum. The rest is history… as the results pushed the Central Bank to postpone the hike (once again) because of global risks.

This vicious circle (chart 1) of market reactions pushing the Fed to reassess its policy is hard to break, and the Central Bank needs the perfect combination of economic strength, job momentum, global risk containment, and strong enough inflation numbers to overpower any factors suggesting a delay. Every time the Central Bank backs down, it creates a confirmation that the next time won't be much different. This skews market expectations of a hike to the downside, thus constantly increasing pressure on the FOMC to postpone.

It's time to break free from this loop



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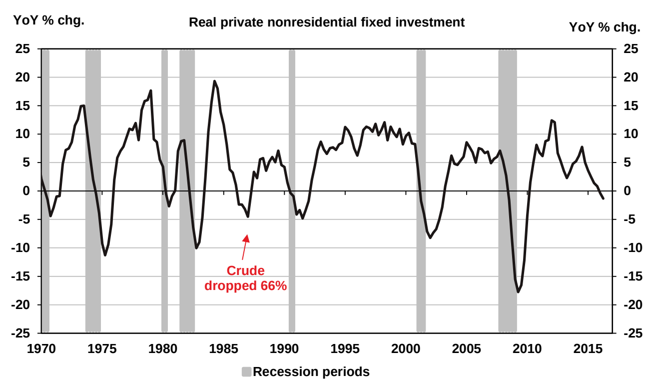
While the members of the committee are probably right to play it safe, this constant hot-and-cold approach has created multiple problems for the Fed regarding the communication of its monetary policy (one of which is the vicious circle we just discussed). These challenges have the potential to create undue volatility as investors play a guessing game not only on the timing of the next hike but also on the pace of future ones. So what is holding the Fed back? The Fed minutes tied to July's meeting gave some clues about the FOMC members' reading on some factors on which they depend to base their decision:

Weak business investments: Business investments are key to generate economic growth, as increased corporate spending generates demand for products which, in turn, creates employment opportunities. Usually, declining corporate spending is tied to an economic downturn. But the current situation may be similar to the 1987 situation (chart 2), as fixed investments drilling and mining structures are subject to a steep drop following the general commodity price downturn. As the commodity prices seem to have bottomed out, we expect this sector's influence on global business investment to fade. Nevertheless, reduced spending in metal and oil infrastructure cannot explain all of the weakness. The next point certainly has an influence on how companies plan their projects.

1987 once again? Crude oil's drop had consequences then



Source: Datastream

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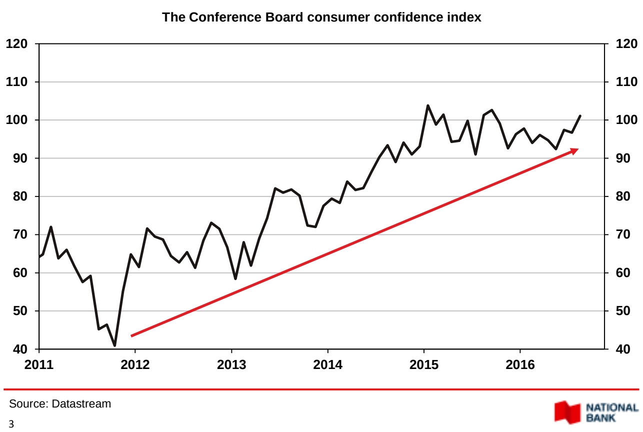
- **Political and economic uncertainty**: If you haven't noticed, Americans are set to vote on November 8 and while both presidential candidates seem to favour some form of fiscal stimulus, the specifics of the plans remain fairly unknown and subject to speculation. We must also remember that in addition to the presidency, there are governors, senators and congressmen to be elected which, depending on the outcome of the vote, could change the legislative field and greatly impact the environment under which companies in different sectors operate. Knowing this, companies seem to have taken a step back to see how the cards will play out in November.

  Economically, the uncertainty comes from outside the U.S. It's undeniable that the Fed is not the only entity keeping a close eye on global risks. In recent years, companies had to contend with a Grexit, Brexit, USD appreciation, Chinese slowdown, and stock market corrections. Now, uncertainty about the medium- to long-term outlook consequences of Brexit, Italian banking problems, and how well China is handling the transition of its economy are all on the radar. Ironically, uncertainty about the Fed's next move is also a factor to consider.

- **U.S. economic situation**: Domestically, while Q2 GDP numbers were fairly disappointing, they are expected to sharply bounce back in the third quarter. Consumer confidence maintains levels close to the post crisis highs (chart 3), and spending has strongly rebounded from Spring lows.

Consumers not rattled by the early 2016 soft patch



Source: Datastream
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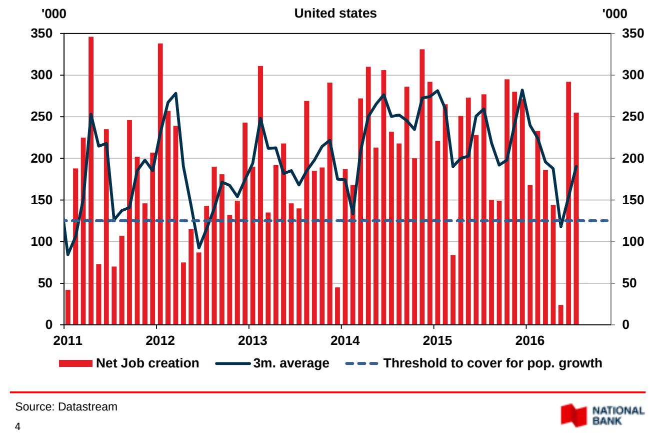
Labour markets are also bright spots. Job creation in June and July more than made up for May's horrible numbers (chart 4), and the three-month average remains well above the requirements to cover for demographic growth. FOMC members noted that wage inflation remains relatively tame. However, some feared that letting labour market conditions tighten could lead up to runaway inflationary pressures that would push the Central Bank to tighten faster than it has initially planned, which would adversely affect the domestic economy.

- **Financial stability**: Other factors members noted are the misallocation of capital and the mispricing of risk which are consequences of the reach for yield (a subject we discussed in our August 2016 letter). Predicting how these investor flows could adversely affect the financial stability of markets is difficult. However, the FOMC is aware that we are in an unprecedented situation. The longer rates remain low, the higher the probabilities are of such an event, which could have important consequences if unaddressed.

May numbers are now a distant memory



Source: Datastream
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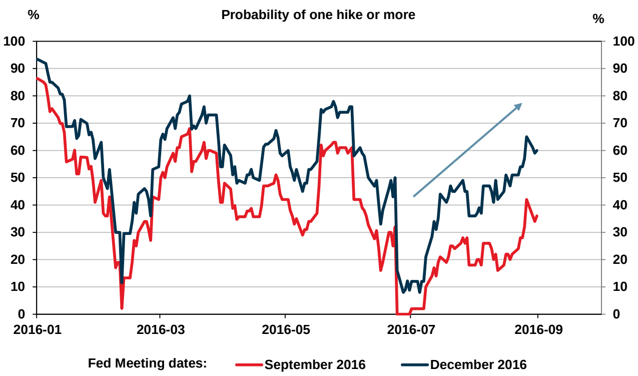
The Fed seems to be waiting for just the right moment to implement a hike this year and a window of opportunity is starting to open up, especially in light of Fed Chair Yellen's speech in Jackson Hole on August 26 where she said that employment numbers will remain the key data point going forward:

> *"While economic growth has not been rapid, it has been sufficient to generate further improvement in the labor market. Smoothing through the monthly ups and downs, job gains averaged 190,000 per month over the past three months. Although the unemployment rate has remained fairly steady this year, near 5 percent, broader measures of labor utilization have improved. . . .*
>
> *in light of the continued solid performance of the labor market and our outlook for economic activity and inflation, I believe the case for an increase in the federal funds rate has strengthened in recent months."*
>
> -Janet Yellen, Jackson Hole, August 16, 2016

This comment follows the different remarks made by various Fed officials during the last weeks that have been suggesting a hike in the near-term. Consequently, the odds of a rate increase are now steadily increasing (chart 5, next page) and good September 2 employment numbers would greatly accelerate the schedule of monetary tightening, and put the next meeting "live."

One strong employment number away from a hike?



Source: Datastream
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Fixed income: Wait-and-see mode

The waiting game has now fully settled in, as investors are anticipating when the Fed will act, or how the economic situation will evolve. However our underlying view is that the Fed will eventually hike during the year which should adversely affect fixed income products. Because of this, we suggest taking a defensive position duration-wise while being more aggressive on the credit side. 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). TIPS have the potential to provide some form of protection against the possibility of rising rates because the underlying economic reason for such a scenario would be an increasing CPI forcing the Fed to tighten its monetary policy. In addition to the transitory nature of the effect coming from the high USD and low commodity prices (chart 6), the potential for fiscal stimulus in the U.S. makes the rising inflation scenario more and more likely in the medium-term. As such, TIPS should offer a better return profile than plain vanilla treasuries.

Currencies: Still neutral

Our view for the greenback hasn't changed much from last month. We expect that the timing of an eventual hike may put some upward pressure on the greenback, but the fact that Fed officials are increasing the rhetoric towards an action will ease the blow once D-Day arrives. Therefore, we think that the range set since the beginning of the year is likely to persist and suggests a neutral position.

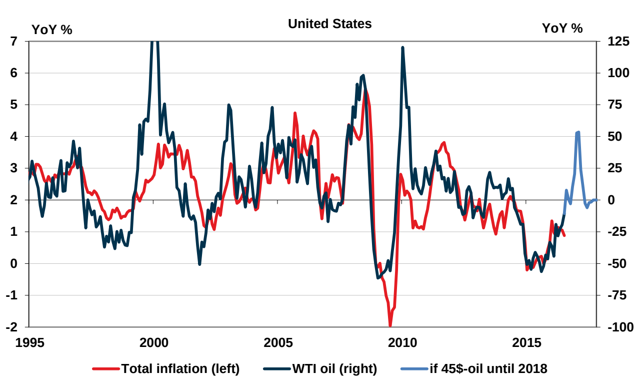
The same can be said for the loonie, which hasn't moved much since May. We do not foresee any major changes in the near future unless crude oil breaks out materially from current levels. However, the currency may experience some volatility due to increased uncertainty in energy market fundamentals (see next section below). Therefore, we suggest taking a neutral approach regarding currency hedges and waiting for opportunities once an attractive level is reached.

Commodities: Hungry for good news

In crude oil, volatility is likely to remain high for the foreseeable future. The rebound since the beginning of the month seems to have been due to a "short squeeze" as speculative positions had reached extreme levels at that time (chart 7). Usually when speculators are tilted too heavily on one side, all it takes is a catalyst for everyone to rush toward the exit sign before profits evaporate. This time, the instigator is OPEC which has hinted at a potential production freeze when members meet in Algeria this upcoming September 26-28. While the probabilities of a successful agreement are still low, the fact that it's on the table sets a temporary floor on prices.

Another source of volatility will come from the supply-and-demand picture. The equilibrium is fragile and, while a deficit is still expected for the second half of 2016, production increases coming from Nigeria, Iraq or Libya are possibilities that could tip the balance toward a surplus. As a consequence, we think the price recovery since the beginning of the month is tenuous, and some downside should be expected in the event of a

Inflation: the clock is ticking



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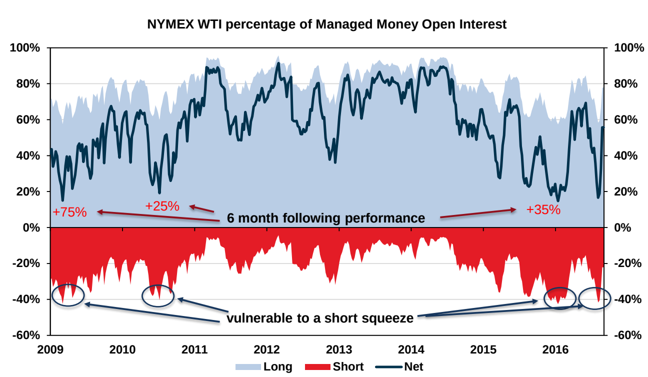
Déjà-vu, all over again!



Source: Datastream
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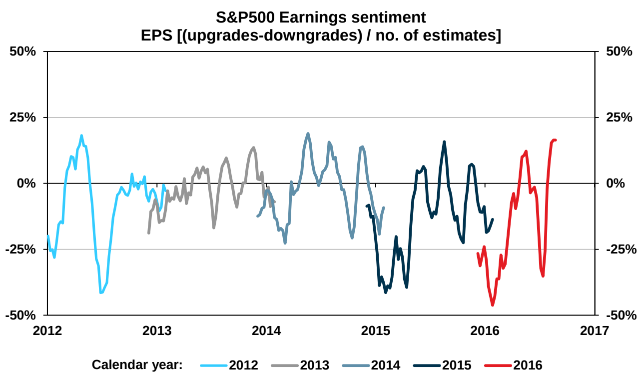
surprise increase in production or headlines lowering the chances of an output freeze agreement.

Equities: Time for sector rotation?

For the S&P500 as a whole, the prospect for better earnings is encouraging (chart 8), a consequence of the expected improvement in the underlying economic background. Even though the Fed is ramping up the hike talk, the financial conditions will remain accommodative for a long period of time and should serve as a favourable environment for growth.

Will earnings live up to expectations?



Source: Datastream

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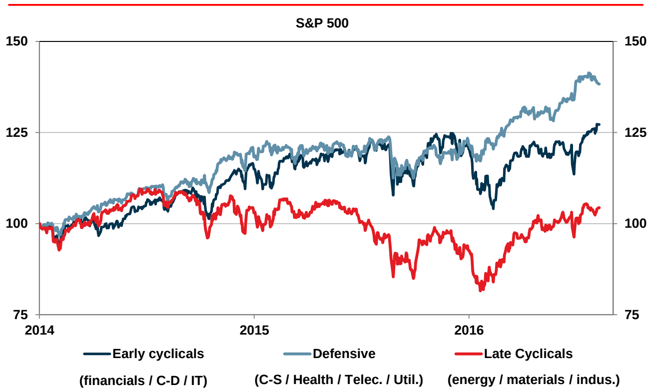
As yield-chasing took hold in fixed-income markets, pushing investors towards assets that have more credit risk but that offer better yields. The same happened in equities as defensive stocks have been the best performers during the last three years (chart 9).

The winds are shifting, sector rotation will be key



Source: Datastream

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These sectors are the ones which have the more "bond-like" properties, as they offer the highest dividend payout percentage for the lowest beta in the index --- particularly telecoms and utilities. The general downtrend in yields have greatly helped these sectors outperform. As we expect the Fed to eventually raise rates, this situation may change as defensives would be very vulnerable to a rate increase. The early cyclicals, especially financials, would be poised to take the lead should the Fed pull the trigger, as rising interest rates boost profit margins for banks and insurance companies.

The S&P/TSX is less diversified than its counterpart south of the border and that makes the decision to rotate investments even more important. As table 3 shows, late cyclicals were the main drivers of performance for the first part of 2016, due to gold's impressive run and the crude market rebound since the lows of January. Defensives suffered from the complete crash of the healthcare sector while other defensives did perform as well as their U.S. counterparts. Going forward, we believe early cyclicals should outperform in an 'interest-rate rising' environment.

Overall, we continue to prefer 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. However, we continue to believe better opportunities lie ahead as equity valuations are not cheap. As a consequence, we suggest keeping some liquidity on hand to invest when they present themselves.

Table 3: **Performance Breakdown**

	H1-2016	rest of the year
Canada (S&P/TSX)	**9.8%**	**4.2%**
Defensives		
Cons. Staples	2.7%	10.4%
Healthcare	-72.3%	21.2%
Telecom.	27.7%	2.4%
Utilities	17.3%	0.1%
Early Cyclicals		
Financials	5.1%	5.2%
Cons. Disc	0.1%	7.6%
IT	-5.7%	10.8%
Late Cyclicals		
Energy	19.3%	2.2%
Industrials	5.3%	10.8%
Materials	52.3%	-3.6%