INVESTING

Asset Allocation Strategy

Never cut what you can untie

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Martin Lefebvre
CIO and Strategist
(514) 412-8572
martin.lefebvre@bnc.ca

Simon-Carl Dunberry
Senior Analyst
(514) 412-8384
simon-carl.dunberry@bnc.ca

Highlights

- Monetary policy tightening was largely discounted for the March meeting as most economic numbers painted a picture that the timing was right. The main point of uncertainty was the dot plot and the FOMC's plans regarding potential future hikes in 2017. The "no change" on the March summary of economic projections (SEP) compared to December 2016 helped assuage those fears.
- We suggest treading cautiously on the duration-side and investing in shorter-term securities or products offering better protection in a rising yield environment (such as non-traditional fixed income), as we still think yields will have a tendency to appreciate by the end of the year. However, the method will be as important as the direction. If we reach 2.60% without any real catalyst such as surprise inflation or a hawkish Fed, we would buy fixed-income products or lengthen the duration of our portfolio, as we think the resistance will hold once again.
- For now, the greenback is stuck in limbo, waiting to see how the rest of the U.S. administration will now be able to shift away from the Affordable Care Act repeal debacle to implement other projects on the agenda, such as tax reform and infrastructure spending. Any failure on that front would put a serious dent not only in the GOP administration's credibility but also in the "Trump trade" projections.
- By digging a little deeper we find that the energy sector currently has an outsized effect on earnings growth, as the sector will contribute 35% of the total S&P 500 earnings. As one would expect, the situation is even worse in Canada as energy represents 50% of the change for 2017. Europe seems to offer better prospects on that front as the sources of growth seem more diversified. Consequently, we still suggest a neutral exposure to equities, but also reduce our negative bias towards Europe.

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

- U.S. 10-year yields exhibited a classic "buy the rumours, sell the fact", peaking slightly over 2.60% as the FED began its 2-day meeting on March 13th and reversed course to end the month at 2.41%.
- In Canada, yields continued to move in sync with their U.S. counterparts with the 10-year bond climbing to 1.86% on March 13th and shifting back to February levels of 1.62%.

Canadian equities

- The S&P/TSX finished 1.3% higher with all sectors but three closing in positive territory.
- Lightweight sectors (Utilities, Consumer Staples, IT) led the pack with gains hovering around 5% followed by Energy and Materials while Financials finished with little change.
- Healthcare once again suffered from Valeant Pharmaceuticals downfall after activist investor Bill Ackman gave up on the drug maker.

U.S. equities

- Equities managed to wrap up the month in positive territory despite some turbulence, in light of a failed healthcare reform casting doubts over Trump's ability to enact his agenda.
- All sectors edged lower in March except for Materials, Consumer Disc. and IT which managed to drag the headline number above zero.

Commodities

- Oil slumped below the $50 mark for most of the month with rising inventories and hedge funds trimming their record bullish positions.
- Nevertheless, crude erased half the drop and climbed back above that threshold in the last days of March on the back of optimism that OPEC will extend output curbs.
- Gold began March weaker but quickly bounced back after the FED stuck to its forecast of just two additional rate rises this year.

Foreign exchange

- The greenback closed little changed as the hit coming from the FED's "dovish" hike was partially offset by growing concerns over policy divergence between the U.S. and European nations later in the month.
- In Canada, the loonie traded at both the lower and upper ends of the $1.32-1.35 range at the whim of crude oil and the U.S. dollar.

Table 2 Market Returns

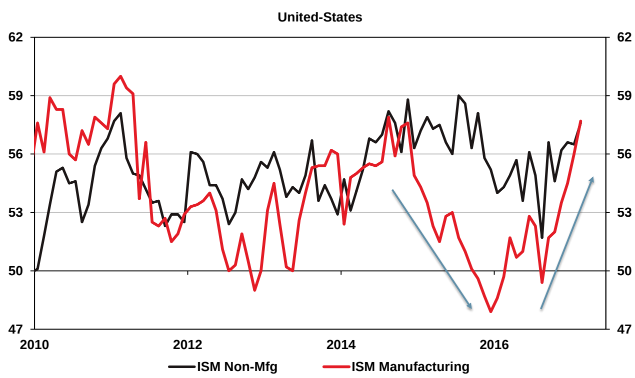
Asset classes	March	Q1	2016
Cash (3-month T-bills)	0.0%	0.1%	0.5%
Bonds (FTSE/TMX Ovr. Univ.)	**0.4%**	**1.2%**	**1.7%**
FTSE/TMX Short term	0.1%	0.7%	1.0%
FTSE/TMX Mid term	0.2%	1.5%	1.6%
FTSE/TMX Long term	1.0%	1.9%	2.5%
FTSE/TMX Government	0.4%	1.0%	0.9%
Federal	0.2%	0.6%	0.0%
Provinces	0.6%	1.4%	1.8%
Municipales	0.7%	1.7%	2.0%
FTSE/TMX Corporate	0.4%	1.8%	3.7%
AA+	0.2%	1.1%	2.0%
A	0.6%	2.1%	3.6%
BBB	0.4%	2.2%	5.1%
BoAML High-Yield (USD)	-0.2%	2.7%	17.5%
Preferred shares	1.8%	7.5%	7.0%
Canadian Equities (S&P/TSX)	**1.3%**	**2.4%**	**21.1%**
Energy	1.2%	-5.5%	35.5%
Industrials	3.1%	5.3%	22.8%
Financials	-0.1%	3.5%	24.1%
Materials	0.9%	6.1%	41.2%
Utilities	5.2%	7.3%	17.7%
Cons. Disc	3.8%	7.0%	10.7%
Cons. Staples	4.8%	2.6%	7.5%
Healthcare	-11.2%	-10.1%	-78.4%
IT	5.4%	7.0%	5.2%
Telecom	3.1%	5.0%	14.7%
REITs	-0.1%	4.7%	9.1%
S&P/TSX Small cap	1.0%	1.5%	38.5%
US Equities (S&P500 / USD)	**0.1%**	**6.1%**	**12.0%**
Energy	-1.0%	-6.7%	27.4%
Industrials	-0.7%	4.6%	18.9%
Financials	-2.8%	2.5%	22.8%
Materials	0.5%	5.9%	16.7%
Utilities	-0.2%	6.4%	16.3%
Cons. Disc	2.1%	8.4%	6.0%
Cons. Staples	-0.3%	6.4%	5.4%
Healthcare	-0.4%	8.4%	-2.7%
IT	2.6%	12.6%	13.8%
Telecom	-1.2%	-4.0%	23.5%
REITs	-1.0%	3.5%	3.4%
Russell 2000 (USD)	-0.1%	2.1%	19.5%
World eq. (MSCI ACWI)	**1.3%**	**7.0%**	**8.5%**
MSCI EAFE (USD)	2.9%	7.4%	1.5%
MSCI EM (USD)	2.5%	11.5%	11.6%
Commodities (CRB index)	**-0.4%**	**1.9%**	**12.9%**
WTI oil (US$/barrel)	-10.5%	-10.0%	44.4%
Gold (US$/ounce)	-0.7%	7.8%	9.0%
Copper (US$/tonne)	-2.5%	5.3%	17.4%
Forex (DXY - US Dollar index)	**-0.8%**	**-1.8%**	**3.6%**
USD per EUR	0.7%	1.4%	-2.9%
CAD per USD	0.1%	-0.9%	-2.9%

Source: Datastream 3/31/2017

Fixed income: A dovish hike sets the tone

Overview: Monetary policy tightening was largely discounted for the March meeting as most economic numbers painted a picture that the timing was right: labour markets maintained a brisk pace of job creation and PMI indicators were showing strength (chart 1). There is also a window of opportunity for the Fed as global risk headlines seemed to wind down, just before some major elections in Europe.

Back to pre-crude downturn expansion levels



Source: Datastream
1

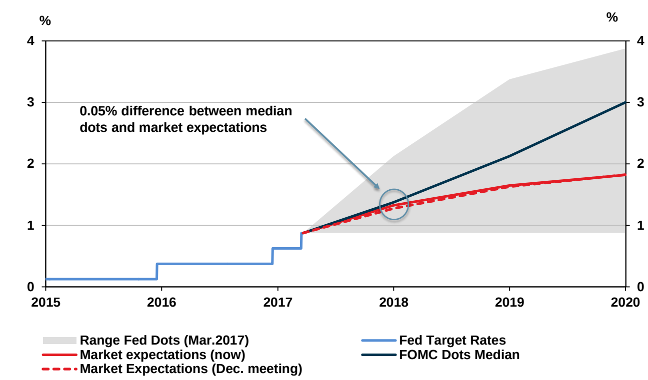
The main point of uncertainty was the dot plot and the FOMC's plans regarding potential future hikes in 2017. The "no change" on the March summary of economic projections (SEP) compared to December 2016 helped assuage those fears and confirmed that caution will prevail as the Central Bank will continue to raise rates while maintaining policy as accommodative as possible.

What needs to be understood, though, is that in setting their course of action, the members did not take into account any potential fiscal plans from the new U.S. administration:

> *"... we have not discussed in detail potential policy changes that could be put into place, and we have not tried to map out what our response would be to particular policy measures. We recognize that there is great uncertainty about the timing, the size, the character of policy changes that may be put in place and don't think that that's a decision, or a set of decisions, that we need to make until we know more about what policy changes will go into effect...*
>
> *... There's nothing that we have done or anticipate that is a speculation. I think it's fair to say, there's nothing that's a speculation about preemptive responses to future policy moves. We have plenty of time to see what happens."*
>
> -Janet Yellen, FOMC press conference March 15, 2017

Therefore the Fed could be more aggressive should the President implement policies that spur inflation, particularly the labor component. For now, a total of three hikes are planned in 2017 and market expectations seem to be in line with the Fed (chart 2).

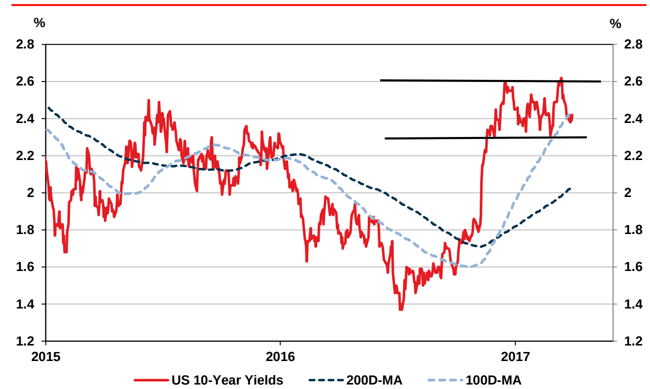
Market and FOMC members agree on hike path for 2017



Source: Datastream
2

Technicals/asset allocation: The Fed hike proved to be the high point since the election. Many investors believe the 2.60% threshold on the 10-year Treasury note yield is level at which the bear market would start for fixed income products. It should act as a resistance while 2.30% will be a support (chart 3). As long as values stay between those two points it will be hard to set a real trend.

What will push yields out of this range?



Source: Datastream
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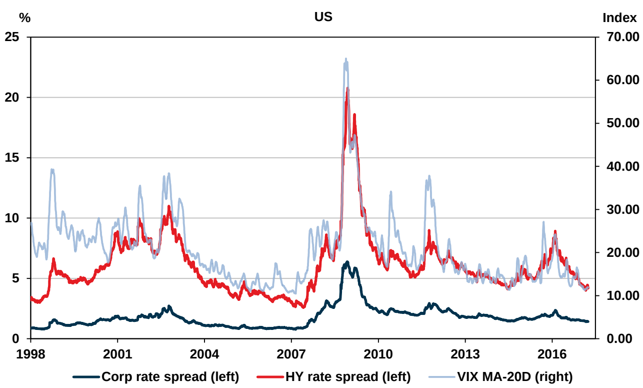
Therefore, we suggest treading cautiously on the duration-side and investing in shorter-term securities or products offering better protection in a rising yield environment (such as non-traditional fixed income), as we still think yields will have a tendency to appreciate by the end of the year. However, on the short-term horizon, the method will be as important as the direction. If we reach 2.60% without any real catalyst such as surprise inflation or a hawkish Fed, we would buy fixed-income products or lengthen the duration of our portfolio, as we think the resistance will hold once again.

For credit, we think the majority of spread contraction is behind us. However, we do not expect a recession any time soon, and corporate earnings should also continue to improve. The higher yield generation will also help in mitigating the lower revenue of being short duration. Some credit spreads such as high yield are more sensitive to uncertainty, and we are now witnessing complacency (chart 4). As such, we think they are more vulnerable than their investment grade counterpart, and would advise caution and not overextend credit risk too much.

High Yield bonds are sensitive to equity volatility



Source: Datastream
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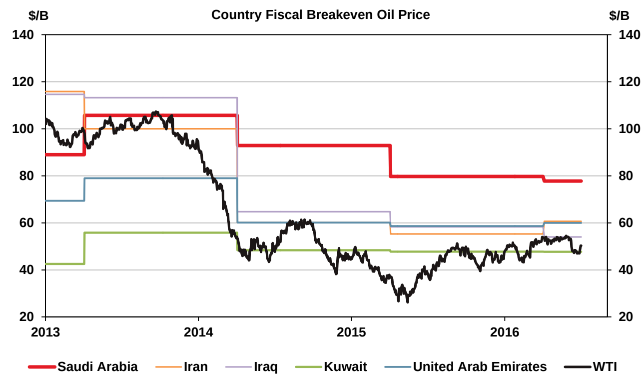
Commodities: crude oil markets now have a Central Bank

Overview: As expected, speculative length reversed back to more sensible levels and took down crude with it. While a 10% drop since the beginning of the month is sizeable, we are only back to the range witnessed before the OPEC deal at the end of November. Now that a floor seems to have been reached, all eyes will be on the ongoing record compliance from the Cartel members and how much the cuts will be offset by growth in the U.S. from shale oil production.

Another factor that will make headlines will be at the next OPEC meeting on May 25 when the committee has to decide whether the agreement needs an extension or not. The supply and demand balance is expected to shift into deficit by Q3-2017. If this scenario unfolds, the initial objective of price stabilization from Saudi Arabia will have been reached. However, if the data coming in shows that the surplus is persistent caused by higher-than-expected output from the U.S., Libya, Nigeria or weakening demand, the members of the Cartel could use their option to continue to stabilize prices until demand finally catches up.

Committees, meeting dates, data dependency, price stabilization… sounds familiar? These are the words usually used when describing the Fed or other Central Banks, and OPEC decided to play that role for the energy markets. At first glance, one would be inclined to think that a spike to $65-70 or more would be a welcome development for the members, but if this situation was to unfold, those higher levels would give an incentive for higher cost producers to either ramp up their operations or restart previously closed projects. Such a scenario would make the supply rise materially, which would mark a return to a sizeable production surplus and defeat the initial purpose of the cuts. Kicking the can down the road is an option OPEC can ill-afford (chart 5). A slow and deliberate price appreciation going forward is clearly the best outcome for the Cartel, and this is our base case scenario for 2017.

WTI down = more social spending cuts



Source: Datastream
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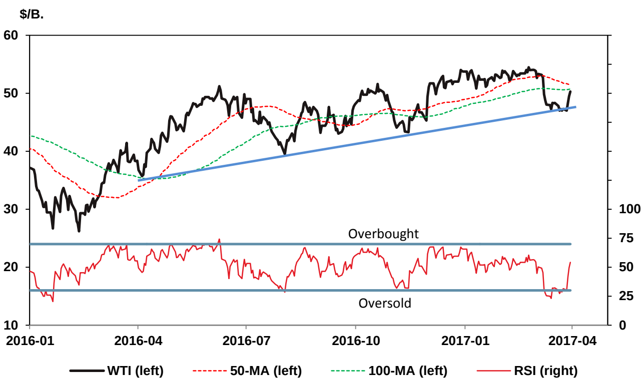
Technicals: As we exited the oversold territory after the selloff, the 50 and 100 MA stand in the way and could act as resistance in the coming weeks, limiting the potential for appreciation (chart 6, next page). If prices were to break through the recent highs around $55, we would expect the next upside levels to be around $60-65, which marked the last range at which crude settled in Q2-2015. On the downside, there is a trend line extending to Q2 2017 that would put support around $49.

Currencies: Shifting sands

Overview/technicals: Bolstered by the reflation trade and expectations that the U.S. monetary policy would follow suit, the greenback rallied 5% from the election to its January 2017 peaks. Optimism has waned since then, as the shine from President Trump's potential policies is starting to lose its luster.

There are still risks to the upside. Any border adjustment tax implementation would be swiftly met with USD strength, and there's also the odd risk that a global or risk off event triggers a flight to quality. But, the timing of such occurrences is difficult to predict. Article 50 has now been called and Brexit

The trendline resisted to speculator sell-off



Source: Datastream

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negotiations can now begin. However, their impact remains unknown.

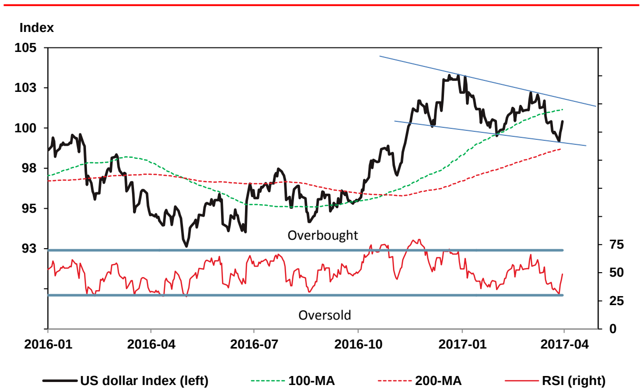
For now, the currency is stuck in limbo, waiting to see how the rest of the U.S. administration will now be able to shift away from the Affordable Care Act repeal debacle to implement other projects on the agenda, such as tax reform and infrastructure spending. Any failure on that front would put a serious dent not only in the GOP administration's credibility but also in the "Trump trade" projections.

Technically, the DXY rebounded on a channel trendline at the same time that the RSI rebounded on the RSI oversold level. We think some support could be found there, as well as the 200D-MA but the 100D-MA could act as a resistance (chart 7).

Canadian dollar/currency hedge:

For the loonie, the situation has improved since last month. We see less downward pressure on the currency coming from crude oil now that levels are lower and speculative length has reverted back to more reasonable positioning. In our view,

A downtrend channel since the beginning of the year



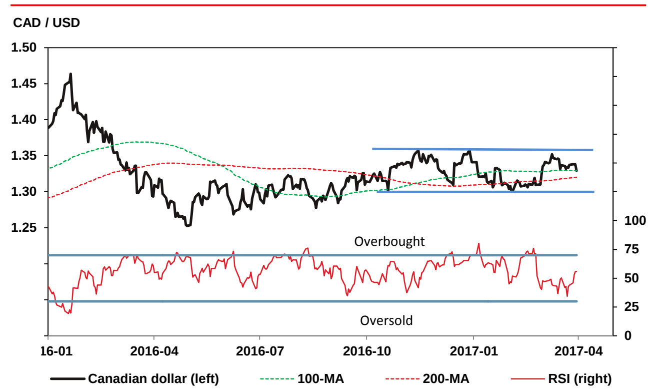
Source: Datastream

7

OPEC now acting as a great stabilizer will also help reduce the potential for a material drop in prices going forward.

While tightening from the Fed was widely expected in March, the fact that the FOMC members' view on the number of hikes in 2017 didn't change from the December 2016 meeting diminishes the potential that additional policy divergence between the two countries will sway the currency pair materially one way or the other. We, therefore, think the range between $1.30 and $1.35 set since Q4-2016 should persist (chart 8). Consequently, we suggest gradually taking a neutral stance regarding the hedge in U.S. dollar investments, especially as the loonie weakens to the top of that range (from previously unhedged).

Tactically trading the range may prove profitable



Source: Datastream

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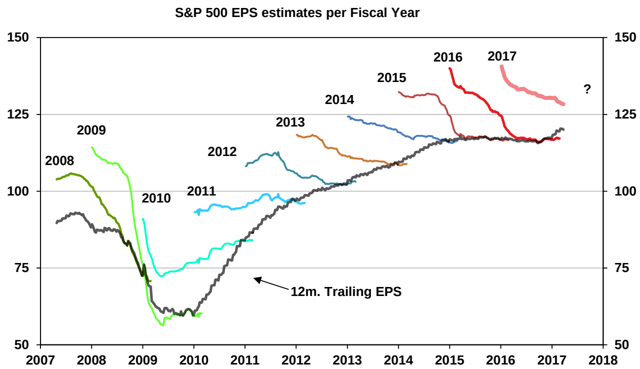
Equities: Beware of energy earnings weight

Overview: As we enter earnings season, the expectations are for year-over-year earnings growth to be around 9.0% for Q1-2017, which would be the highest figure since Q4-2011. By taking a longer view, we see that since the beginning of the year expectations for 2017 have somewhat diminished – but not at the same pace as we witnessed in the previous years (chart 9, next page).

By digging a little deeper we find that the energy sector currently has an outsized effect on those figures, as the sector represents roughly 7% of the index but will contribute 35% of the total S&P 500 earnings growth (table 3, next page). True, a 184% increase in profits for companies operating in the sector looks impressive, but it's only because they were so low to begin with, as margins remain fairly thin. This means that any incremental percentage of growth in the energy sector is highly dependent on the selling price of crude oil (chart 10, next page). As one would expect, the situation is even worse in Canada as energy represents 50% of the change for 2017.

2017 earnings expectation have resisted well for now



Source: Datastream
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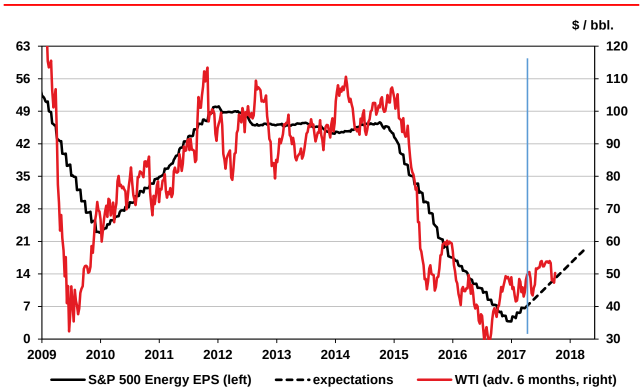
Table 3: **Index Earnings Growth Breakdown**

	S&P 500	S&P/TSX	MSCI Eur.
Earnings Growth Rate (next 12 months)	**10.7%**	**23.0%**	**14.5%**
Sector	**Sector Contribution to earnings growth**		
Info tech.	22.5%	1.2%	2.0%
Cons. disc.	7.8%	3.1%	13.8%
Financials	21.8%	23.3%	22.8%
Real-Est.	-6.7%	-4.4%	0.8%
Industrials	3.4%	3.4%	7.0%
Energy	35.3%	57.5%	23.4%
Materials	3.5%	16.2%	16.8%
Utilities	0.0%	-0.9%	-0.4%
Cons. stap.	4.7%	2.1%	9.7%
Heatlhcare	7.8%	-2.2%	3.2%
Telecom.	0.2%	0.8%	0.9%

Source: Datastream and I/B/E/S

Crude oil prices still explain the majority of EPS moves



Source: Datastream
10

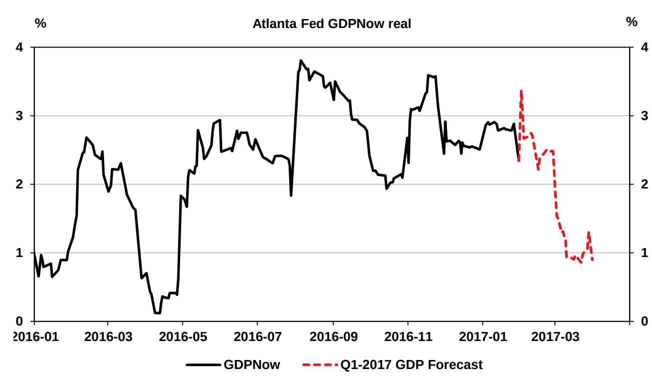
There are multiple factors entering in the profitability of companies, such as hedging and cost cutting. But, at the end of the day, the main drivers of performance will remain crude oil prices. And, while this is not the scenario we anticipate (see the commodities section), we think this lack of diversity in the composition of profit expansion in the North American equity markets could put the indices in a vulnerable state, should energy prices underperform. We can also notice in table 3 that Europe seems to offer better prospects on that front as the sources of growth seem more diversified.

Earnings aside, another factor to consider will be the possible tax reform implemented by the Trump administration. The question remains if the GOP can regroup and set aside previous differences to make it happen. While infrastructure spending and reduced regulations were the two other promises made that spurred the "Trump Trade", the tax plan is the one that has the potential to have the most impact, and negotiations with the Freedom Caucus will be difficult. For now, equity markets have taken the news in stride, but there are some indications that the confidence in the administration to pass it are slowly fading.

__Asset allocation__: As we look at most financial assets, it seems clear that the last month has been more in "wait and see" mode. Most have been range-bound for a few months now, a situation which also had the effect of lowering realized and implied volatility. It makes us wonder if this is more a result from lack of conviction than outright complacency.

To be fair, there are a lot of unknowns which could affect returns in a material way, most of which are political in nature. On one side the U.S. economy is doing very well and consumer confidence is high. But, some measures such as GDP now are starting to dampen expectations a bit (chart 11). The potential for disappointment in the U.S. is gradually increasing, as it seems the President is unable to fully rally the GOP behind his

A weaker GDP ahead according to Atlanta Fed



Source: Atlanta Fed
11

plans while we believe Europe can potentially surprise to the upside.

True, some political risks exist in that region also, as the French Elections and the Brexit negotiations are sure to make the headlines in the following weeks or months. However, the odds of Le Pen winning are slowly decreasing as Macron is gaining traction. As well, we believe Brexit will take a long time to get sorted out and both the EU and UK have an incentive to reach a deal that will do as little damage as possible. Consequently, we still suggest a neutral exposure to equities, but also reduce our negative bias towards Europe.