INVESTING

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Asset Allocation Strategy

The loonie is spreading its wings!

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Highlights

- Following the rebound in Q2 US GDP growth and job creation in 2017 on target to match the 2016 pace, we still expect another hike by year end with some form of balance sheet reduction unless there's a negative surprise on inflation numbers.
- In Canada, as expected, the BoC increased its overnight rate by 25 basis points, which was largely expected. The tone however was very optimistic with the central bank projecting the output gap to close at the end of the year while reaching its inflation target of 2% by mid-2018.
- Our positioning in fixed income doesn't change compared to last month, we keep a neutral exposure but with a short duration twist. As the BoC is now in comeback mode regarding removal of accommodative policies, we believe US fixed income products will outperform their Canadian counterparts.
- In light of recent speculative positioning changes and our technical indicators showing the Canadian dollar being in overbought territory, we think being proactive regarding our currency hedges is the best course of action and suggest reverting back to neutral.
- For oil prices, recent OPEC internal tensions put into light the possibility for the agreement to fail or break down, thus increasing the risks to the downside. However, we think compliance will remain high, for now. As such, we still expect a slow and gradual price appreciation by year-end.
- We maintain our Europe overweight given that monetary conditions remain loose, economic momentum is picking up and growth potential remains attractive.
- We also keep our bias in favor of Canadian equities in light of attractive relative valuations, better risk/reward profile and improving macro conditions.

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	□	□	■	□	□
Infrastructure	□	□	■	□	□

Source: Consulting Investment Committee

Current Allocation ■

Previous Month Allocation ░

NATIONAL BANK

Market review

Fixed income

- Yield on the U.S. 10-year benchmark inched higher in July with the FED remaining confident in the country's outlook, even as it acknowledges weak inflation readings.
- In Canada, 10-year rates surged 30 bps to settle just above the 2% mark, a first since November 2014 when oil prices were just beginning to fall.

Canadian equities

- The S&P TSX closed almost unchanged with the bulk of Q2 earnings expected to be released over the next few weeks.
- Performances were mixed sector wise, with energy and materials advancing on the back of improving commodity prices, while industrials and consumer stocks suffered.

U.S. equities

- The S&P 500 edged 2.1% higher in July, bolstered by a whopping 73% of companies having reported Q2 earnings that beat estimates.
- Gains were broad-based with telecom stocks emerging with a 6.4% price increase, followed by technology (+4.3%) and energy (+2.5%) equities.

Commodities

- Despite a tumultuous start to the month, oil prices closed 9.1% higher, helped by weakness in the U.S. dollar and 4 straight weeks of U.S. crude stocks decline.
- Copper prices also benefited from the continued dollar retreat and leapt by 6.9% to a 2-year high, boosted by reports that China could ban imports of scrap metal by the end of 2018.

Foreign exchange

- The loonie surged 3.7% against its U.S. counterpart with the Bank of Canada raising rates for the first time since 2010 on the back of rapid economic growth and buoyant property prices.
- The U.S. Dollar index ended the month down 2.9%, completing five straight months of decline, stung by a mix of nerves over the rate outlook and political paralysis.
- In that context, the Euro remained on its 2017 bullish trend, reaching levels last seen in January 2015.

Table 2 **Market Returns**

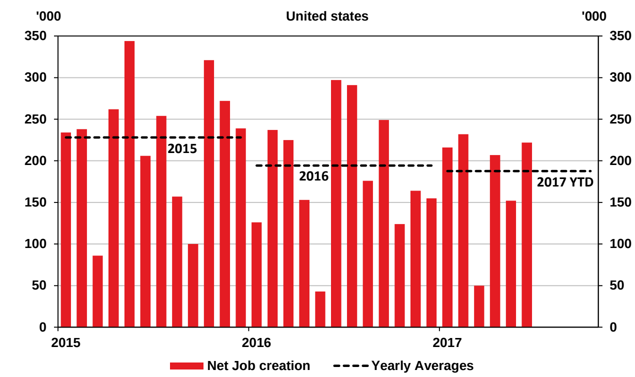
Asset classes	July	YTD	2016
Cash (3-month T-bills)	0.1%	0.3%	0.5%
Bonds (FTSE/TMX Ovr. Univ.)	**-1.9%**	**0.4%**	**1.7%**
FTSE/TMX Short term	-0.4%	-0.2%	1.0%
FTSE/TMX Mid term	-1.5%	-0.2%	1.6%
FTSE/TMX Long term	-4.3%	1.5%	2.5%
FTSE/TMX Government	-2.1%	0.0%	0.9%
Federal	-1.6%	-0.7%	0.0%
Provinces	-2.7%	0.8%	1.8%
Municipales	-2.2%	1.3%	2.0%
FTSE/TMX Corporate	-1.4%	1.4%	3.7%
AA+	-0.6%	0.2%	2.0%
A	-1.7%	2.2%	3.6%
BBB	-1.3%	1.8%	5.1%
BoAML High-Yield (USD)	1.2%	6.1%	17.5%
Preferred shares	1.1%	9.9%	7.0%
Canadian Equities (S&P/TSX)	**-0.1%**	**0.7%**	**21.1%**
Energy	2.1%	-11.5%	35.5%
Industrials	-4.0%	7.3%	22.8%
Financials	0.3%	2.8%	24.1%
Materials	1.7%	1.0%	41.2%
Utilities	-1.9%	8.0%	17.7%
Cons. Disc	-2.7%	9.2%	10.7%
Cons. Staples	-3.1%	1.1%	7.5%
Healthcare	-5.1%	-3.3%	-78.4%
IT	-1.2%	8.1%	5.2%
Telecom	1.5%	9.2%	14.7%
REITs	-2.0%	3.8%	9.1%
S&P/TSX Small cap	0.0%	-4.1%	38.5%
US Equities (S&P500 / USD)	**2.1%**	**11.6%**	**12.0%**
Energy	2.5%	-10.4%	27.4%
Industrials	0.1%	9.6%	18.9%
Financials	1.7%	8.7%	22.8%
Materials	1.5%	10.9%	16.7%
Utilities	2.4%	11.4%	16.3%
Cons. Disc	1.9%	13.1%	6.0%
Cons. Staples	0.6%	8.6%	5.4%
Healthcare	0.8%	17.0%	-2.7%
IT	4.3%	22.3%	13.8%
Telecom	6.4%	-5.1%	23.5%
REITs	1.2%	7.7%	3.4%
Russell 2000 (USD)	0.7%	5.0%	19.5%
World eq. (MSCI ACWI)	**2.8%**	**15.0%**	**8.5%**
MSCI EAFE (USD)	2.9%	17.5%	1.5%
MSCI EM (USD)	6.0%	25.8%	11.6%
Commodities (CRB index)	**-1.1%**	**4.4%**	**12.9%**
WTI oil (US$/barrel)	9.1%	-6.6%	44.8%
Gold (US$/ounce)	2.0%	9.6%	9.0%
Copper (US$/tonne)	6.9%	14.7%	17.4%
Forex (DXY - US Dollar index)	**-2.9%**	**-9.1%**	**3.6%**
USD per EUR	3.4%	11.8%	-2.9%
CAD per USD	-3.7%	-7.1%	-2.9%

Source: Datastream 7/31/2017

Fixed income: Less accommodation in the cards

While central bankers are looking for elusive signs of inflation (please refer to our July 2017 letter for more details), the employment side of the Fed's dual mandate is being met. In fact, not only did payrolls beat expectations in June, we also witnessed some material upward revisions to the previous month. Consequently, job creation in 2017 now seems to be on target to match the 2016 pace (chart 1) which is no small feat considering most would expect some form of lower figures as we approach full employment.

Job creation: 2017 closing in on 2016's pace



Source: Datastream

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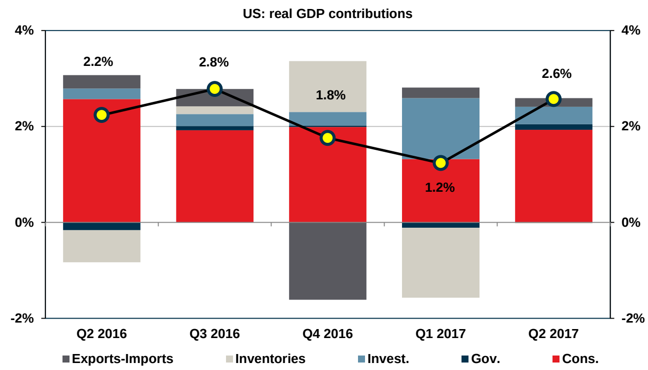
One of the reasons for such stellar performance has been the continued increase in the participation rate which has the added effect of putting a lid on wage growth. Whether the effect takes a couple more months or quarters is up for debate, but the Fed will have to choose the course of action wisely for the rest of the year.

While doves want to wait for some indication the inflation target of 2% is sure to be met, hawks see too much risk in undertaking that course of action deeming inflationary pressures as prone to a sudden surge which would force the Central Bank to slam on the brakes down the road. Nevertheless, both will certainly embrace the solid rebound in GDP figures in Q2, putting aside some concerns that followed the sluggish growth numbers earlier this year (chart 2).

Financial stability is also a factor in the equation by the FOMC members, a subject that has been broached multiple times in meeting minutes or speeches. Before the first hike in 2015, the Central Bank was worried about a surging U.S. dollar and the impact tightening would have on emerging markets and commodity prices. These factors were continuously pushing the

A Q2 rebound should ease the Fed's concerns



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decision process toward delays. Now, the situation is completely different and excessive risk-taking is on the radar:

> *"Some participants suggested that increased risk tolerance among investors might be contributing to elevated asset prices more broadly; a few participants expressed concern that subdued market volatility, coupled with a low equity premium, could lead to a buildup of risks to financial stability."*
>
> -FOMC minutes for the June 2017 meeting

Consequently, unless there's a negative surprise on inflation numbers, we still expect another hike by year-end with some form of balance sheet reduction.

North of the border, the BoC increased its overnight rate by 25 basis points, which was largely expected. The tone, however, was very optimistic, with the Central Bank projecting the output gap to close at the end of the year while reaching its inflation target of 2% by mid-2018. The mood in bond markets has certainly changed, not only in Canada but also in foreign markets as monetary policy is being recalibrated in light of better-than-expected growth figures and Central Bank governors publicly pondering the gradual removal of policy accommodation.

Bottom line: Our positioning does not change relative to last month. We are keeping a neutral exposure in fixed income but with a short-duration twist. As the BoC is now in comeback mode regarding removal of accommodative policies, we believe U.S. fixed-income products will outperform their Canadian counterparts. Consequently, we suggest U.S. exposure investment grade bonds hedged in Canadian dollars[1] for which

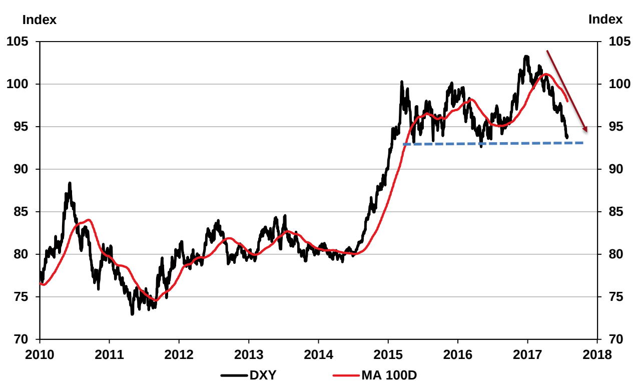
[1] *Our U.S. investment grade allocation is considered a rate differential/carry trade and will remain hedged in Canadian dollars for as long as we have this position in our books. Consequently, it should be exempt from any suggestions regarding currency hedges of the overall asset allocation.*

the positive carry should help the class outperform treasuries, as spreads do not have a tendency to widen materially when the economy is growing.

FX: High-flying loonie; greenback seeing red

The ECB's evolving stance didn't just influenced yields, it also had an impact on the greenback which is now down 10% since the beginning-of-the-year highs (chart 3). Another factor to consider has been speculation which has seen U.S. dollar longs exiting the market since the start of Q2-2017 in favour of the euro and the loonie (chart 4).

Will the support hold?



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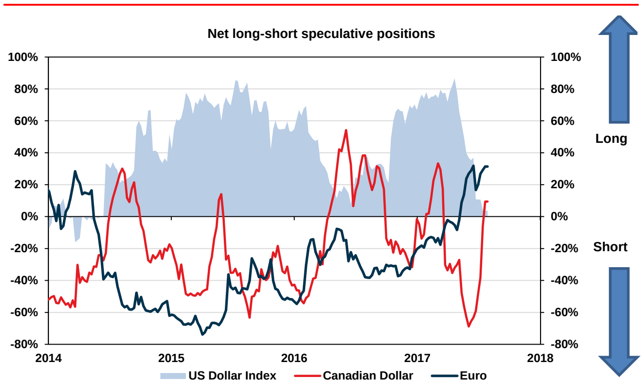
USD Longs quickly closed-out their positions



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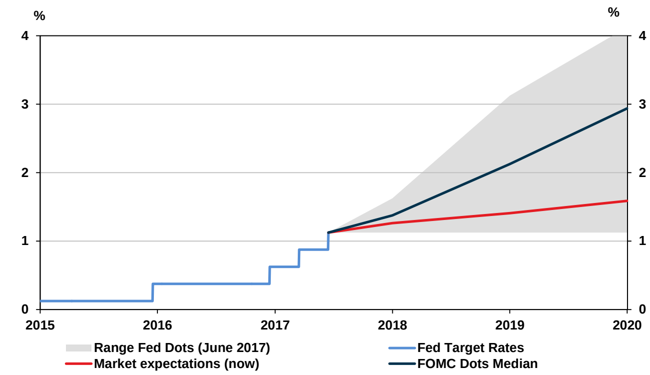
The text following the Fed's July meeting specifically underlined that the "Committee is monitoring inflation developments closely." As such, the next major move in yields should depend on future inflationary pressures, as well as the tone of the FOMC Chair Yellen regarding the course of action going forward.

Currently, the market seems to be more dovish than the Central Bank (chart 5), so a stay-the-course position from FOMC members could lift the greenback. Additionally, we cannot

Fed anticipations are more hawkish than the market



Source: Datastream
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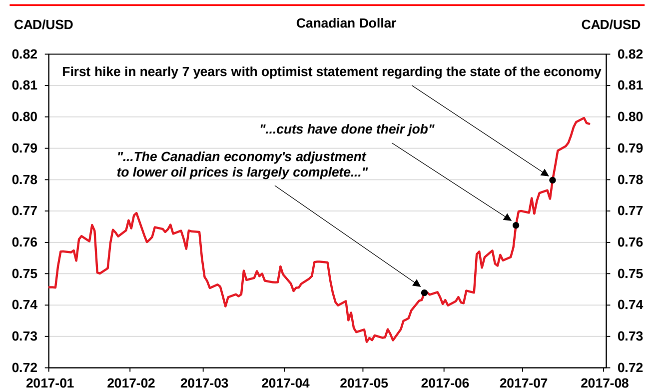
ignore Brexit negotiations that are always simmering in the background and which could weaken the euro at any moment. However, these potential developments would take longer to materialize, and the trend is decidedly bearish on the short-term horizon.

For the loonie, the wind has certainly changed since May, thanks to a more aggressive BoC (chart 6). Since the financial crisis, we've only seen one time period when the Canadian dollar has shot up so dramatically (chart 7). When looking at chart 7, we notice most of these significant movements were either caused by exogenous risks (such as the financial crisis) and/or crude oil fluctuations. However, the current spike has been mainly caused by monetary policy decisions.

Energy levels are an important factor for the Canadian dollar, and we expect the currency to be contaminated from time to time by increased volatility in crude oil markets. Monetary policy

The history of a takeoff



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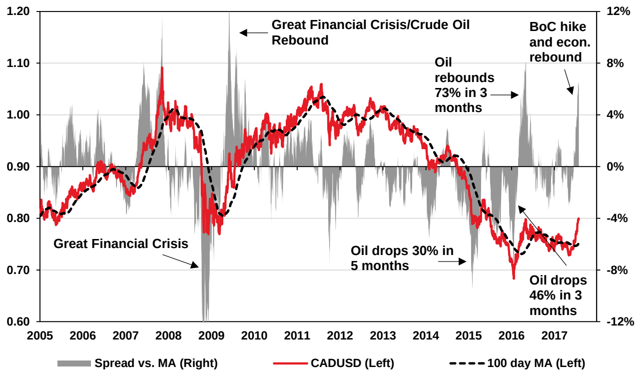
Crude is usually the driver of volatility in the loonie



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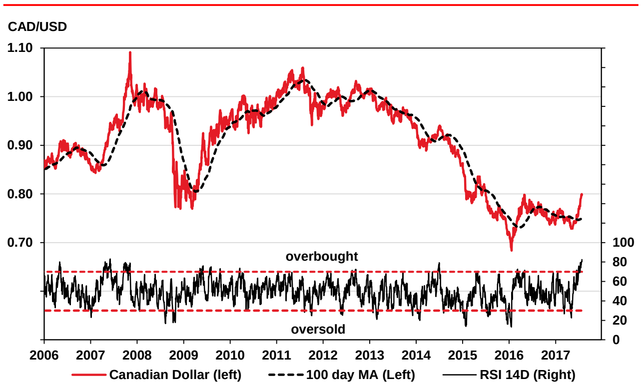
decisions or divergence are other matters as central banks usually strive to communicate their plans well in advance.

In light of this, it is possible the loonie could have a little more to run on the upside as investors continue to assess whether inflation in the U.S. will stay muted and if the Canadian economy rebound has more legs. However, we believe that movements are closing-in on the overstretched territory (chart 8), and we think crude oil markets have some added vulnerabilities which will necessitate more clarity in the coming months (please refer to the commodities section).

Bottom line: In light of recent speculative positioning changes and our technical indicators showing the Canadian dollar being in overbought territory, we think being proactive regarding our currency hedges is the best course of action and suggest reverting back to neutral.

The last time the CAD was this overbought is… 2007!



Source: Datastream
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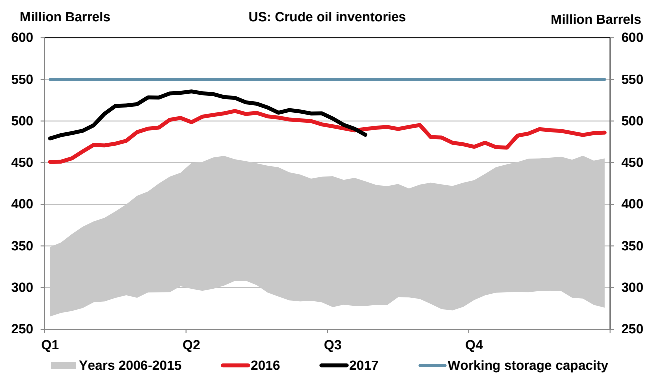
Commodities: Tug of war

OPEC seems to be at the centre of all news regarding crude oil these days. The recent rebound has been caused by bigger-than-expected inventory draws in the U.S, (chart 9), and a wide range between \$42 and \$55 seems to be forming. There's still uncertainty regarding the rebalancing of the supply and demand picture, and the following two points will probably be the deciding factors for energy market performances for the rest of the year:

Back to last year's inventory levels



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1. **<u>OPEC vs. OPEC cheaters:</u>** Despite the abundance of headlines about record overall compliance with the cut agreement, Saudi Arabia and Russia are still not fully satisfied with the state of affairs, particularly when looking at individual country compliance.

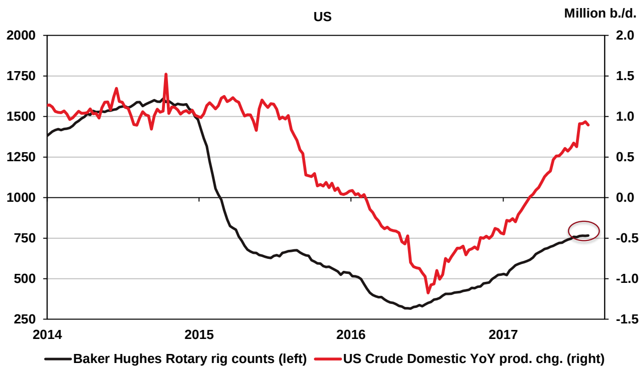
   In a rare show of impatience, the Saudi Arabian energy minister said: "*We are not doing this (the cuts) to allow other countries a free ride and to undercut the agreement by overproducing,"* while his Russian counterpart stressed that OPEC's supply would be 200,000 barrels per day (bpd) less if the agreement reached 100% compliance.

   These warning shots are worrying because they show some cracks in a united front regarding the agreement. The cartel is struggling to be the main stabilizer of supply, and the need to control becomes more pressing as the supply-and-demand normalization is not happening as quickly as initially expected. The next point is the main reason.

2. **<u>OPEC vs. shale oil:</u>** The cartel was surprised by the response from U.S. producers, which is basically a confirmation that controlling prices will be more and more difficult as U.S. shale oil takes a bigger proportion of the total pie. This means that any price increase will be met by increased production until we have reached maximum capacity in the U.S. which can take some time. However, the contrary is

also true, as we are already seeing rigs plateauing in light of the recent performances in energy markets (chart 10).

Is US production reaching a plateau?



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The agreement is only trying to ease the supply glut until demand can catch up. For now, it is set to end in March 2018, but OPEC is mulling over an extension should the situation warrant it.

Recent OPEC internal tensions brought to light the possibility of the agreement to fail or break down, thus increasing risks to the downside. However, we think compliance will remain high, for now. As such, we still expect a slow and gradual price appreciation by year-end.

Equities: Earnings in the spotlight; Canada set to catch up

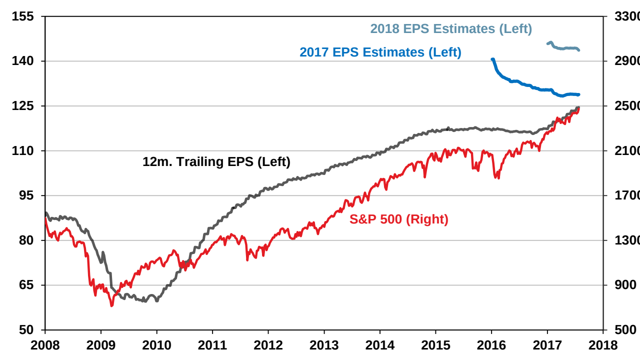
U.S. equities got a boost from solid corporate profits with Q2 earnings season in full swing, but major indices holding near record highs further fueled correction fears. Nonetheless, results lived up to expectations with 73% of U.S. companies beating estimates from the 58% of companies having reported so far. Hence, trailing 12-month S&P 500 earnings stand alongside price levels near all-time highs with estimates for FY2017 growth (+9.7%) and FY2018 growth (+11.9%) both holding steady (chart 11).

Canadian earnings season is still early in the process with only 23% of listed companies having published results, of which 60% came in better than expected. While corporate profits have yet to fully recover from the oil price slump, the climb back up holds firm with estimates for FY2017 and FY2018 growth at 19.5% and 13.2%, respectively (Chart 12).

Global equities have come a long way since bottoming out in March 2009 but all countries did not emerge above pre-crisis highs the same way the U.S. did. As you can see on Chart 13, the S&P 500 is well ahead of the pack, supported by extraordinary monetary measures taken by the FED early on that have helped push forward both the headline index and corporate profits.

In Canada, the S&P TSX is only marginally above October 2007 levels, a relatively poor outcome heavily influenced by the energy sector meltdown which saw its earnings estimates drop

S&P 500 earnings are living up to expectations



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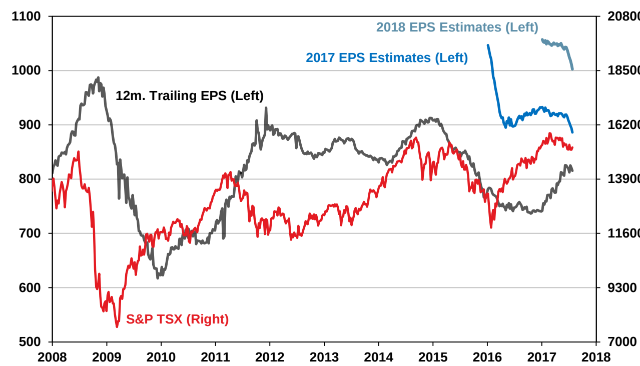
S&P/TSX earnings growth will depend on energy



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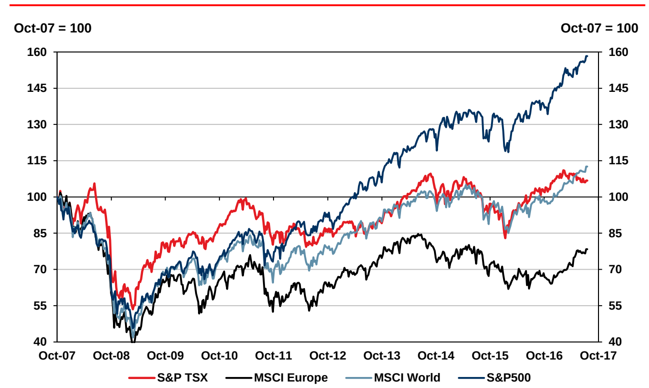
Major indices since the S&P 500 peak in 2007



Source: Datastream
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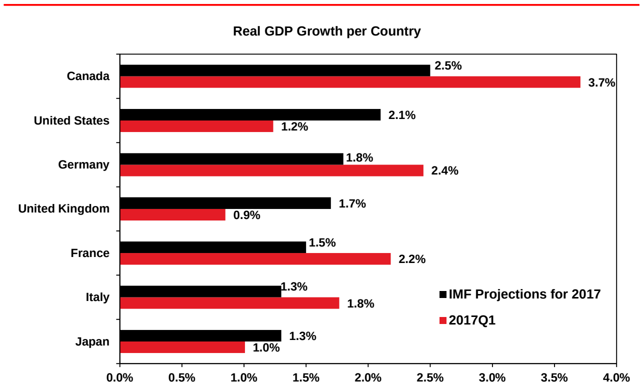
to roughly a third of what they were a decade earlier. However, given our expectation for slow and gradual oil price appreciation and the improving economic momentum favouring the other 80% of the index, we believe the risk/reward profile for Canada stands out.

Europe is certainly the laggard as politic and monetary rigidities associated with the common currency set the scene for episodes of taper tantrum and sovereign debt crisis. Nevertheless, with both soft and hard data finally on the rise, we believe the current macro backdrop favours the region and remains supportive for equities.

Speaking of macro backdrop, in its July 2017 World Economic Outlook Update, the IMF revised its growth projections up for both the euro area (+0.2pp to 1.9%) and Canada (+0.6pp to 2.5%), primarily reflecting diminished political risk in Europe and the buoyant domestic demand in Canada. Economic momentum is clearly picking up in the great white north as the 3.7% surge in Q1 GDP is well on track to be match soon enough. Indeed, the stunning May growth figures prompted our economics research team to increase their forecast to 3.5% for Q2 and 2.9% for 2017. Besides, the IMF marked down its forecast for the U.S. (-0.2pp to 2.1%) as anticipation for a boost coming out of fiscal stimulus abated. This means that Canada is expected to top the G7 growth in 2017, a first since 2013 and a potential lift to foreign investors' sentiment toward the somewhat left-out Canadian equity market (chart 14).

Canada firing on all cylinders



Source: IMF: World Economic Outlook Update, July 2017

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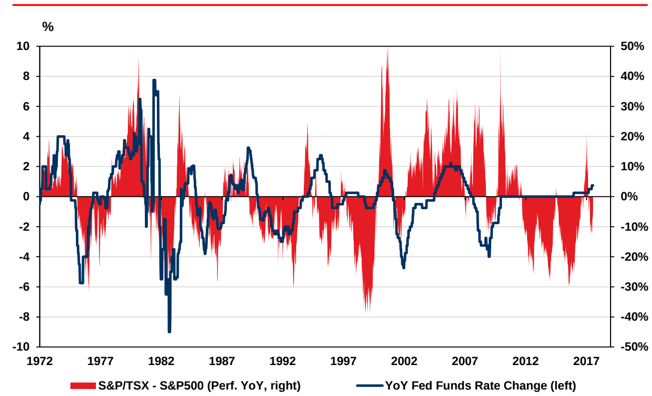
To be fair, GDP growth doesn't always rhyme with equity returns, especially in Canada where the index is marred by a sector allocation highly tilted toward banks and energy, while carrying relatively low exposure to some other sectors of the economy that are fired up right now. Moreover, the sharp rise in the loonie against its biggest trade partner could eventually exert pressure on global companies reporting in CAD. But we're nowhere near the parity range of 2010-2013, and this time the factor pushing the currency pair around (rising rates) happens to be a positive for the biggest S&P/TSX Sector (Financials), a stark contrast to the weak oil/weak loonie story.

Notwithstanding whether the next move is in December or early 2018, the FED remains on track to keep pushing rates higher. As such, we continue to expect Canadian equities to take the lead, as periods where the FED is in tightening mode tend to synchronize with TSX leadership over its U.S. counterpart (chart 15). Topping the list of signals favouring Canadian equities: the valuation gap between the S&P 500 and the TSX has recently reached extreme levels that have historically been followed by the wind changing in favour of our side of the border. Indeed, looking at price/earnings differentials, the TSX stand roughly 2.0x lower than its southern neighbour, a level that preceded the last two Canadian equities comebacks, boding well for the second half of the year. (chart 16).

Fed tightening rhymes with S&P/TSX overperformance



Source: Datastream

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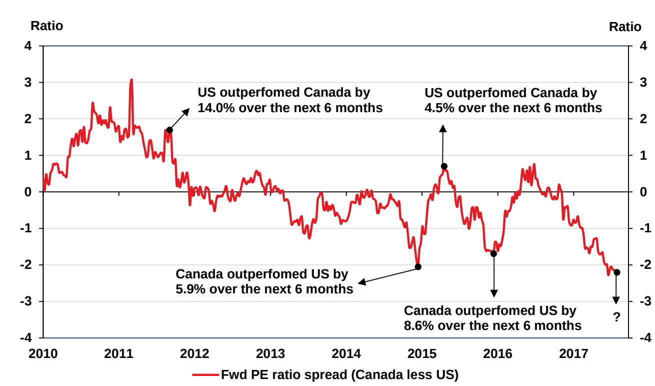
Valuations seems to favor Canadian equities



Source: Datastream

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Bottom line: We maintain our Europe overweight given that monetary conditions remain loose, economic momentum is picking up, and growth potential remains attractive. We also keep our bias in favour of Canadian equities in light of attractive relative valuations, a better risk/reward profile, and improving macro conditions.