January 4, 2017

INVESTING

Asset Allocation Strategy

@realDonaldTrump: #over-promise, #under-deliver?

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Highlights

- Fixed income products seem poised to shift back to their more traditional role of offering a hedge against downside risks, rather than being a real driver of positive returns in a traditional asset-mix, as the heydays of the big bond bull market now seem to be ending.
- Asset allocation decisions must be based on relative comparisons, and credit products look attractive in this light compared to government bonds, especially under the current economic conditions. This should limit the potential for defaults. We are aware that our suggestion of being short duration implies a loss of term-premium revenue. Taking credit risk helps us mitigate this shortfall.
- While it is undeniable that the environment materially improved for the whole energy complex, the equilibrium remains fragile. High prices will enact a response from U.S. producers and will quickly suffer from downside pressure. This situation should persist until we have reached the full production capacity in the U.S.
- Technically, this is the third major bull market for the USD since the 70’s and there is potential for further appreciation. Until other major central banks start moving their stance towards a more restrictive monetary policy, the path of least resistance for the greenback will be to increase in relative value.
- How equities fare in 2017 will depend on how much earnings growth corporations will generate: will it be enough to compensate for unattractive? On the short-term horizon, we believe equities are vulnerable to a pullback once the optimism generated by promises of tax reform and infrastructure projects wanes. Therefore, we suggest a neutral position for the time being.

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

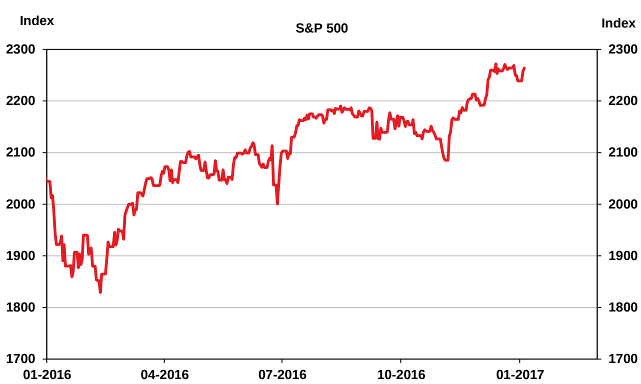
Market review

"Investors should remember that excitement and expenses are their enemies. And if they insist on trying to time their participation in equities, they should try to be fearful when others are greedy and greedy only when others are fearful."

\- Warren Buffett

One word to describe markets overall in 2016 would be "resilient". Worries about China's growth, the sharp deterioration in the energy sector's corporate credit, and contagion risks to other asset classes such as emerging markets were the focus at the start of 2016. To keep markets on its toes, the UK people unexpectedly decided in June to leave the European Union, the Americans elected in November one the most controversial candidate in its history, and the yuan closed the year 6.5% weaker. In such an environment, how could anyone have expected an eight consecutive year of positive performance for the S&P 500 (chart 1)?

Comeback kid



Source: Bloomberg

1

The reasons for such resilience are multiple:

1. Energy prices rebounded materially from their $26 lows in February, partly due to OPEC trying to strike a deal with Russia and production cutbacks in North America. This rebound eased credit problems tied to energy producers and emerging markets.
2. The Federal Reserve (Fed) took a prudent approach towards monetary policy tightening. The stance remained accommodating in light of obvious risks and markets benefitted.
3. The U.S. economy remained healthy while facing global risks. Although growth was not stellar, the possibility of a recession remained low, despite the earnings downturn, with manufacturing activity rebounding sharply.

Table 2 Market total returns

Asset classes	December	Q4	2016
Cash (3-month T-bills)	0.1%	0.1%	0.5%
Bonds (FTSE/TMX Ovr. Univ.)	**-0.5%**	**-3.4%**	**1.7%**
FTSE/TMX Short term	0.0%	-0.5%	1.0%
FTSE/TMX Mid term	-0.3%	-3.1%	1.6%
FTSE/TMX Long term	-1.3%	-7.5%	2.5%
FTSE/TMX Government	-0.6%	-4.0%	0.9%
Federal	-0.6%	-3.3%	0.0%
Provinces	-0.6%	-4.9%	1.8%
Municipales	-0.5%	-3.8%	2.0%
FTSE/TMX Corporate	-0.2%	-1.8%	3.7%
AA+	-0.2%	-0.8%	2.0%
A	-0.2%	-2.9%	3.6%
BBB	-0.1%	-1.6%	5.1%
BoAML High-Yield (USD)	2.0%	1.9%	17.5%
Preferred shares	3.6%	5.3%	7.0%
Canada (S&P/TSX)	**1.7%**	**4.5%**	**21.1%**
Energy	1.4%	7.0%	35.5%
Industrials	-0.6%	5.3%	22.8%
Financials	3.5%	11.5%	24.1%
Materials	-0.6%	-6.2%	41.2%
Utilities	3.0%	-0.4%	17.7%
Cons. Disc	1.8%	1.5%	10.7%
Cons. Staples	-0.2%	-1.5%	7.5%
Healthcare	-5.1%	-28.6%	-78.4%
IT	-1.1%	-0.5%	5.2%
Telecom	1.7%	-2.8%	14.7%
REITs	3.7%	0.1%	9.1%
S&P/TSX Small cap	3.9%	3.1%	38.5%
US (S&P500 / USD)	**2.0%**	**3.8%**	**12.0%**
Energy	1.9%	7.3%	27.4%
Industrials	0.5%	7.2%	18.9%
Financials	3.9%	21.1%	22.8%
Materials	0.1%	4.7%	16.7%
Utilities	4.9%	0.1%	16.3%
Cons. Disc	0.1%	2.3%	6.0%
Cons. Staples	3.2%	-2.0%	5.4%
Healthcare	0.7%	-4.0%	-2.7%
IT	1.6%	1.2%	13.8%
Telecom	8.1%	4.8%	23.5%
REITs	4.4%	-4.4%	3.4%
Russell 2000 (USD)	2.6%	8.4%	19.5%
World eq. (MSCI ACWI / USD)	**2.2%**	**1.3%**	**8.5%**
MSCI EAFE (USD)	3.4%	-0.7%	1.5%
MSCI EM (USD)	0.3%	-4.1%	11.6%
Commodities (CRB index)	**0.8%**	**5.1%**	**12.9%**
WTI oil (US$/barrel)	8.7%	11.4%	44.4%
Gold (US$/ounce)	-1.4%	-12.4%	9.0%
Copper (US$/tonne)	-5.0%	13.9%	17.4%
Forex (DXY - US Dollar index)	**0.7%**	**7.1%**	**3.6%**
USD per EUR	-0.6%	-6.1%	-2.9%
CAD per USD	0.0%	2.3%	-2.9%

Source: Datastream 12/30/2016

If you followed Warren Buffet's advice in the first quarter, you netted a stellar performance for 2016. The S&P 500 price index, after the worst start of the year in history, recorded a 22%-jump to finish the year up 9.5% (chart 2).

Worst start to year on record!

Performance of the S&P 500 (price index)

Year	First 28 trading days	Rest of year	Annual
2016	-10.51%	22.40%	9.54%
1948	-9.22%	9.43%	-0.65%
2008	-8.80%	-32.55%	-38.49%
2009	-7.70%	33.75%	23.45%
1932	-7.64%	-7.73%	-14.78%
1960	-7.35%	4.72%	-2.97%
1957	-7.18%	-7.69%	-14.31%
1970	-6.47%	7.03%	0.10%
1982	-6.44%	22.66%	14.76%

Source: Bloomberg
2

While US equity returns were better than expected for many, they pale in comparison to the Canadian equity market, which after lagging its US counterpart over the past six years finally staged a huge comeback with a 21% total return in 2016, the best of the developed world in Canadian dollar terms (chart 3).

The TSX finally outperforming its peers!

Equity market performance (total return) in C$

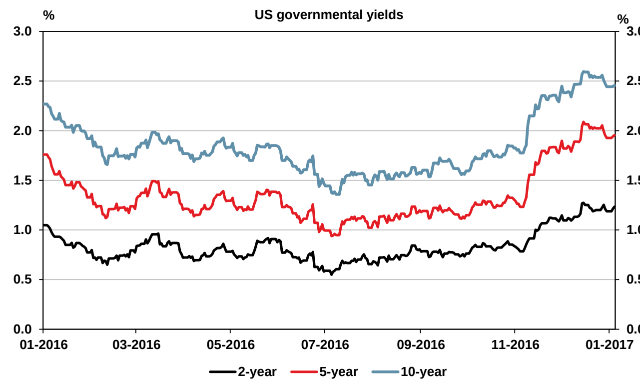
	S&P/TSX	S&P500	MSCI Japan	MSCI UK	MSCI Germany	MSCI France
2011	-8.7%	4.3%	-12.2%	-0.3%	-15.6%	-14.1%
2012	7.2%	13.0%	5.4%	12.2%	28.5%	19.5%
2013	13.0%	42.0%	36.3%	29.2%	41.8%	36.7%
2014	10.6%	24.0%	5.3%	3.5%	-1.3%	-0.4%
2015	-8.3%	20.7%	30.9%	10.2%	17.6%	20.0%
2016	21.1%	8.3%	-0.3%	-3.0%	0.4%	2.9%

Source: Bloomberg
3

As per the US markets, the reversal in energy prices was a boon for the Toronto index, with the energy sector recording a 27% gain in 2016. Gold mining stocks were up even more averaging a near 50% return for the year. However, the main contribution came from the "heavy-weight" financial sector, which finished the year 24% up, on the back of better interest margin expectations.

For fixed income, Mr. Trump's election and promises of reflation completely changed the trend and the environment. The 10-year Treasury yields' jump of 1.1% since July lows is certainly impressive, although they are only up 0.2% on a yearly basis (chart 4).

Half a year down, half a year up



Source: Bloomberg
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On the foreign exchange side, Brexit results weighed down the Euro considerably, which lost 7.6% of its value vs. the U.S. dollar since the vote. For the loonie, the policy divergence between the Fed and the Bank of Canada had a huge impact on the currency pair as the Canadian dollar only gained 2.9% in spite of crude oil rebounding 45% in 2016.

Fixed income: Higher inflation and yields

Since the U.S. election results, the environment seems much less friendly for treasuries; it feels like we have reached the last innings of the great bull market started in the 1980's. So what is in line for 2017? We think one should focus on the following points, which will greatly influence fixed income products in the next quarters.

1. **Inflation and acceleration of the pace of rate hikes**: The energy component will start having a positive effect on CPI (chart 5). U.S. domestic growth is expected to pick up in the next quarters, which, when tied to labor markets' continued strength and tightness, will increase wage inflation down the road. President-elect Trump's fiscal policy, which relies on infrastructure investments and tax reform, will also amplify inflationary pressures in the next quarters/years. Trump's policy comes at a time where slack in the U.S. has greatly diminished and the core PCE should reach the Fed's target by the end of the year.

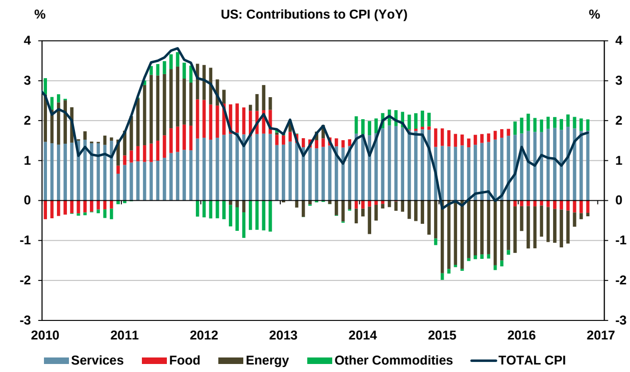
   It will be interesting to see how the Central Bank will react. Chair Yellen stated that the FOMC was willing to let the economy "run a little hot" to ensure it is not removing accommodative policies too soon. However, this statement was made before the addition of a much more aggressive potential fiscal plan from the legislation and, as a consequence, we think the Fed will now take a more traditional approach to monetary policy. Investors reacted to the new environment by agreeing with the FOMC and are now expecting 2 to 3 rate hikes in 2017 (chart 6).

2. **Deficits increasing treasury supply:** We touched on the Fed and inflation side, but one must also remember that if Mr. Trump implements his promises, deficits will increase and so will the volume of treasuries emitted to finance new spending programs and reduced tax revenues. As such, this additional volume should put upward pressure on U.S. treasury yields.

Bottom line: Fixed income products seem poised to shift back to their more traditional role of offering a hedge against downside risks, rather than being a real driver of positive returns in a traditional asset-mix, as the heydays of the big bond bull market now seem to be ending.

We believe the coming year will be one where it pays off to tread cautiously on the duration side. Therefore, we suggest investing in shorter-term securities or products offering better protection in a rising yield environment such as non-traditional fixed income. If you have to invest in longer durations, we suggest investments with an inflation tilt. Choosing TIPS over the more traditional assets would help protect investments from inflationary forces (chart 7).

Energy component will contribute to inflation in 2017



Source: Bloomberg
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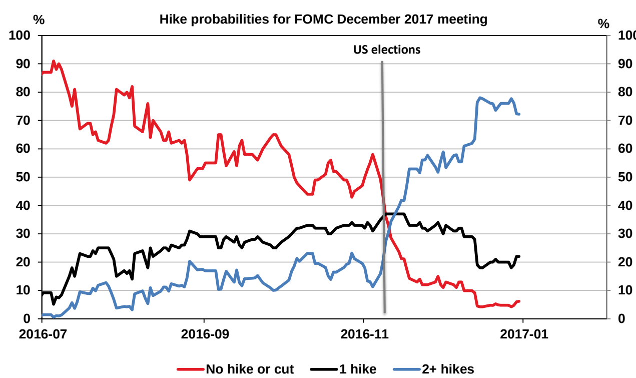
Inflation = hikes



Source: Bloomberg
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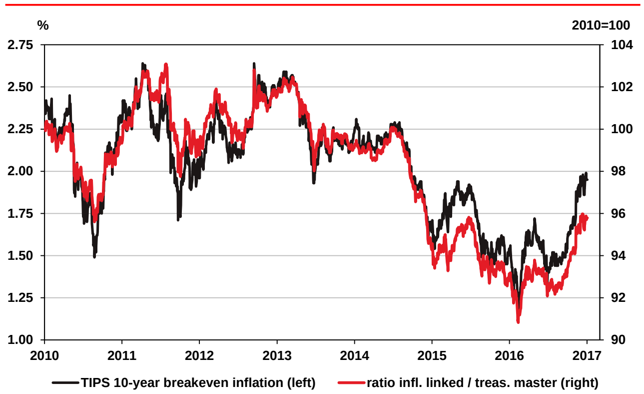
Still some room to go for TIPS?



Source: Datastream
7

Credit: No recession? No problem

For credit, especially the high-yield type, 2016 has been the year of the great turnaround, as the once bad apple of the bond markets became the star, posting an incredible 17.5% for the year. While we think the positive trend can persist for a while, we do not expect the same type of performance in 2017.

1. **<u>Spreads should remain low as the economy continues to improve</u>:** As commodities (especially energy prices) rebounded since the Q1-2016 lows, high-yield defaults have greatly diminished and spreads have tightened materially (chart 8). Now that crude levels have stabilized, the potential for continued improvement of credit in this sector will fade.

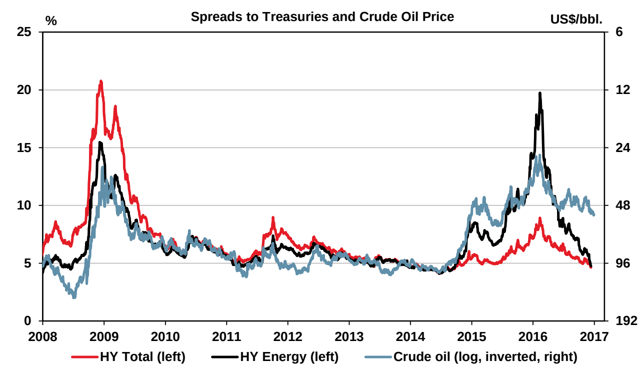
   Unless there is a recession, spread products usually outperform less risky assets and 2017 should not be an exception. We also expect the corporate earnings' non-existent/weak growth witnessed in the last quarters to finally reverse course, show more vigor and improve investment-grade fixed-income spreads down the road.

2. **<u>Carry trade potential should persist</u>:** While the overall yields have rebounded since the July trough, they are still very low on an historical basis (chart 9). Consequently, we continue to believe that the added rewards coming from credit risk will be attractive enough for yield chasers, as there are very few alternatives to generate interesting returns (chart 10).

Bottom line: Asset allocation decisions must be based on relative comparisons, and credit products look attractive in this light compared to government bonds, especially under the current economic conditions. This should limit the potential for defaults. We are aware that our suggestion of being short duration implies a loss of term-premium revenue. Taking credit risk helps us mitigate this shortfall.

However, we doubt the asset class will benefit as much from credit spreads tightening in 2017 as much as it did in 2016. As such, we expect the risk-reward to be less favorable compared to what we witnessed recently. There is also a form of asymmetry in the returns and risk profile: a potential downturn or slowing down of the economy would be met with much higher losses and volatility than the positive outcome from a strengthening of fundamentals. This would affect high-yield bonds much more than their investment-grade counterparts. Therefore, we suggest taking a cautious approach and not overextend risk.

A welcome relief from crude oil



Source: Datastream
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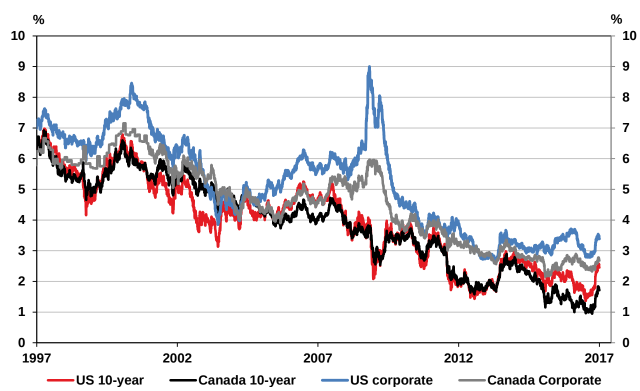
The recent rebound in a long-term perspective



Source: Datastream
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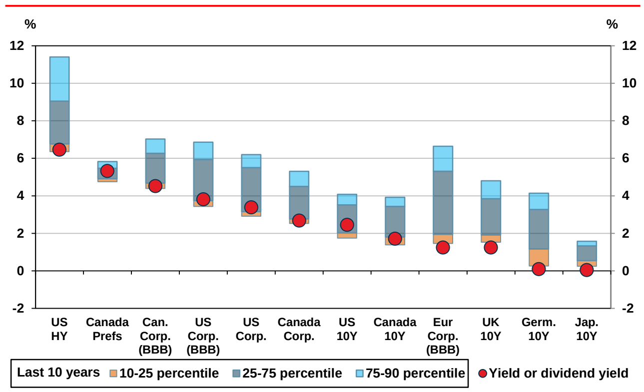
Yield chasing should persist



Source: Datastream
10

Commodities: OPEC cheating and U.S. rig counts

The rout in energy prices came to an end in 2016 as crude prices rebounded an impressive 105% since their February lows. Most energy companies have OPEC to thank for this reversal of fortunes, as the production quotas effectively put a floor on prices and brought confidence back in energy markets. The deal struck at the end of the year greatly reduces the time required before demand catches up to supply, a welcome development considering world inventories were close to record highs (chart 11). Most of the negative drivers for prices have effectively been removed or drastically reduced, but some of the points enumerated below have the potential to limit the upside in the next quarters.

1. **<u>OPEC cheating and Libya ramp up</u>:** There will be increased focus on evidence that the cuts are working and that we are drawing down on inventories. Respect of the deal quotas is far from certain (chart 12) and while no one foresees 100% compliance, too much cheating would defeat the purpose of the deal and put energy prices at risk of another downturn.

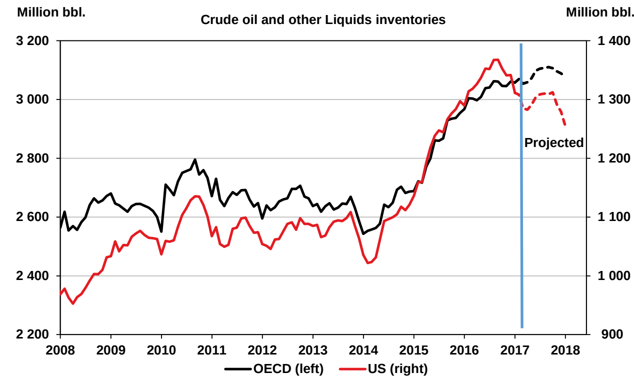
   There is also Libya, who is unconstrained by the deal. The country announced plans to restart fields that produce approximately 400 thousand barrels per day. In response, Saudi Arabia seems to be willing to cut even further to achieve the stated goals of the cartel, but there is probably a limit to which overproduction by other OPEC members can be mitigated.

2. **<u>U.S. rig count response to higher prices:</u>** Another roadblock for price appreciation will come from North American production taking advantage of better profit margins. U.S. rig counts started rebounding when crude prices reached $50 (chart 13), which is not a coincidence since these levels are the break-even price point for some shale oil production centers in the U.S. American companies have shown great ingenuity in the face of adversity and we expect a pick-up in activity if margins justify it.

Bottom line: While it is undeniable that the environment materially improved for the whole energy complex, the equilibrium remains fragile. High prices will enact a response from U.S. producers and will quickly suffer from downside pressure. This situation should persist until we have reached the full production capacity in the U.S.

There are also risks tied to lower demand growth from China, or other emerging markets growing slower than expected. The greenback's continued appreciation could also weigh down prices. Consequently, for the next quarters we expect a slow and deliberate appreciation in energy levels punctuated by bouts of increased volatility.

A reversal on the horizon for world inventories



Source: Bloomberg
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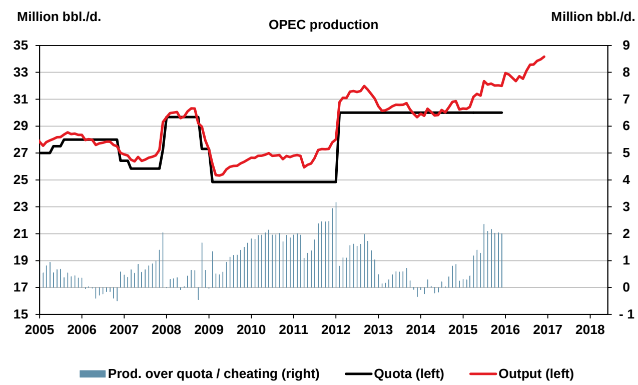
Quotas anyone? Cheaters will be cheating



Source: Bloomberg
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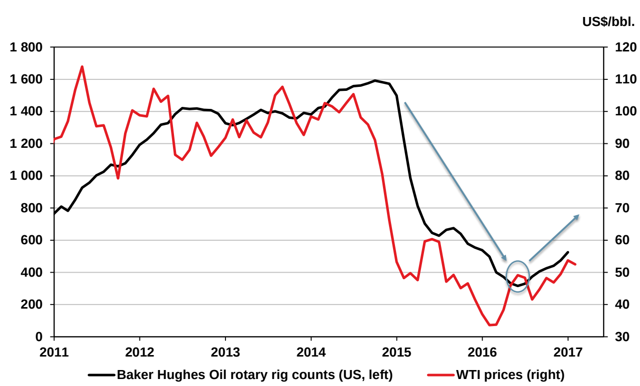
Prices around 50$ seems to be the breakeven point



Source: Bloomberg
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Currencies: Monetary policy divergence drives the show

The aftermath of the U.S. elections, which increased the likelihood of higher economic growth and added to a higher potential pace of rate hikes from the Fed, pushed the greenback through major resistance points and levels unseen since 2003. Whether the trend continues or not will depend on the following factors:

1. **<u>Policy divergence length and intensity</u>**: Fundamentally, a large trade deficit and the potential for a rise in the fiscal deficit should be met with a weakening currency. However, when compared to other economic zones, the U.S. is in much better shape and, consequently, the Fed seems to be the only major central bank in a monetary tightening mode (table 3).

   While not in our base case scenario, if 2017 was to be a repeat of 2016 and 2015 where the U.S. central bank continually postponed hikes, or if economic growth doesn't live up to expectations, we would expect the dollar to weaken. However, the reverse is also true (a stronger dollar), especially if the Brexit aftermath is worse than expected or China shows signs of trouble.

2. **<u>Yuan depreciation</u>**: At the end of 2015/beginning of 2016, all eyes were on the Yuan's weakness and what it meant for China's economic growth. Those fears have subsided, but the weakening trend has continued and Mr. Trump is putting a spotlight back on the currency pair by threatening to label China as a currency manipulator.

   China's currency reserves (chart 14) show that the PBOC is trying to curb the currency's depreciation, but capital outflows are still too strong, in spite of the country's efforts to tighten its controls. A runaway or even overnight depreciation would certainly re-ignite fears about China's growth deceleration and trigger a flight to quality, which would push the greenback higher against its Chinese counterpart.

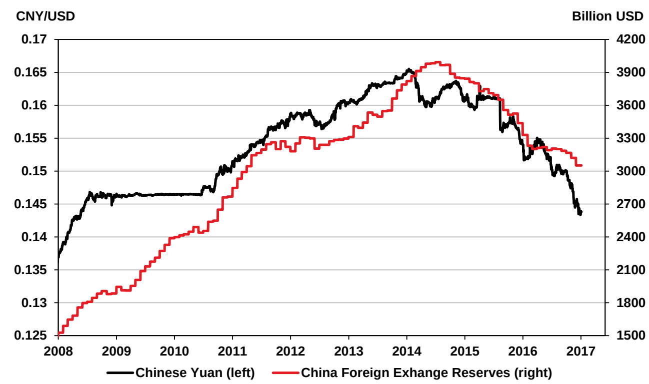
Bottom line: Technically, this is the third major bull market for the USD since the 70's and as we can see in chart 15 there is potential for further appreciation. Until other major central banks start moving their stance towards a more restrictive monetary policy, the path of least resistance for the greenback will be to increase in relative value.

Consequently, we expect the loonie to remain under pressure as Canadian policy divergence from the U.S. has the potential to overshadow any support coming from commodity price strength and economic growth seems to have stalled recently. Therefore, we suggest a large portion of investments in USD unhedged for the time being.

Table 3: **Central bank policies**

Fed	**Stance**	Tightening
	Outlook	Expect 3 hikes in 2017. Higher inflation expectations in light of the legislation's potential fiscal plan. Maintains cautious approach towards hikes.
ECB	**Stance**	Accomodating
	Outlook	Asset purchase program expected to continue through 2018 at a reduced pace. No expectations of hikes for at least two years
BOJ	**Stance**	Accomodating
	Outlook	Maintain the 10-year yield at 0%. No expectations of cuts unless extraordinary situation or Yen extreme appreciation
BoC	**Stance**	Accomodating
	Outlook	Slower than expected rebound in the aftermath of the energy downturn. Discussed the possibility of additional stimulus in October.

The PBOC is swimming against the current



Source: Bloomberg
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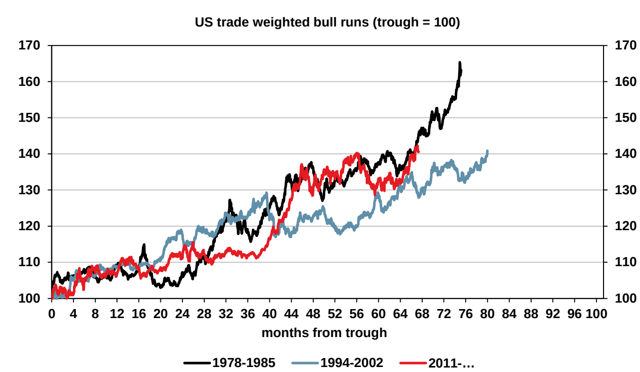
There could still be 8 to 12 months left for the bull run



Source: Bloomberg
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Equities: Optimism vs. reality

Equities were pretty much stuck within a specific range for the good part of the year until Mr. Trump's election, when renewed optimism stemming from the potential for tax reform and new fiscal policies pushed prices to new highs. The next President and, consequently, equities now have to live up to those promises if stocks are to perform this year. The following points have the most potential to affect this asset class.

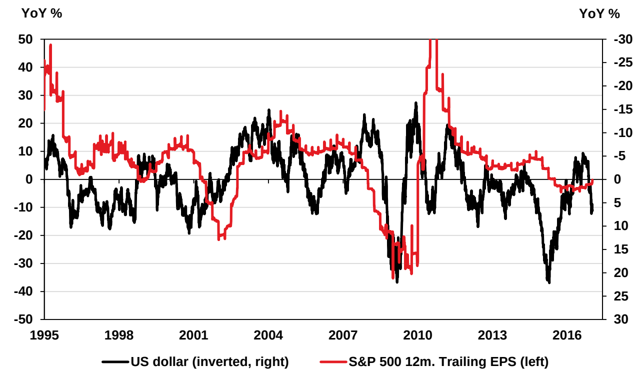
1. **Greenback strength and wage inflation**: One roadblock towards EPS growth will be the U.S. dollar gaining strength. Companies in the S&P 500 generate close to half their revenues in foreign markets and currency risk cannot be ignored (chart 16). It is also undeniable that low wage inflation helped the corporate bottom-line. Now that we expect salaries to pick up, this tailwind should subside.
2. However, most of these problems do not normally occur in isolation. Salaries picking up means that labor markets are still strengthening and that the underlying economic environment is doing well. We clearly have a favorable environment for increased corporate revenues and consumption growth.
3. **Rates impact:** The key to success for investing in equities might well lie in choosing the right sectors. The overall downward trend in yields certainly helped defensives and low-volatility funds outperform their counterparts (chart 17). However, we expect this trend to reverse, as the bull market in bonds ends and so should the defensive sectors over-performance. Once infrastructure plans become clearer, cyclicals should be favored.

   If a low yield environment helped P/E ratio expansion, the reverse is also true. When the Fed is tightening, financial ratios usually improve, which is a headwind for the asset class as earnings growth does not fully translate to stock market returns.

Bottom line: How equities fare in 2017 will depend on how much earnings growth corporations will generate: will it be enough to compensate for unattractive valuations (chart 18)? On the short-term horizon, we believe equities are vulnerable to a pullback once the optimism generated by promises of tax reform and infrastructure projects wanes. Therefore, we suggest a neutral position for the time being.

Canadian equities had an incredible run in 2016, but we think the chances of having an encore are unlikely. Most of the projections in earnings growth for next year come from the energy and materials sectors, which makes us think the impact of higher commodity levels is probably priced-in.

US dollar strength is usually a headwind for EPS growth



Source: Bloomberg
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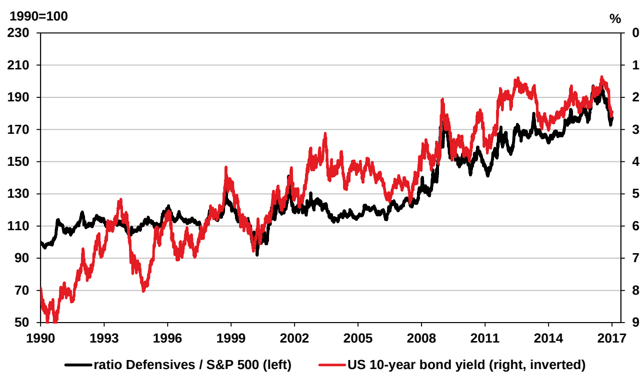
The end of the defensive's era?



Source: Bloomberg
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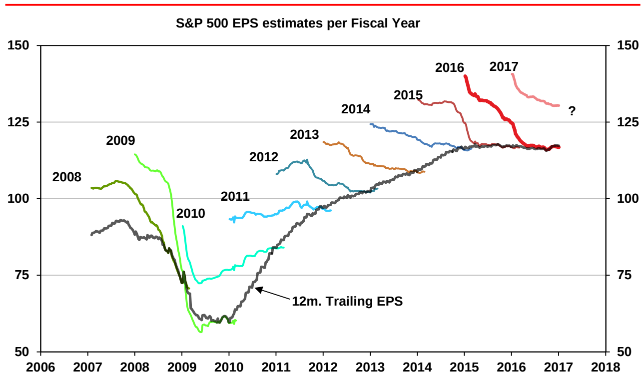
2017 earnings have to deliver on their promises



Source: Bloomberg
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Asset allocation:

While most of our choices are tactical in nature, one cannot ignore the undercurrents. Ultimately, they will determine a big portion of the overall allocation returns over the long term.

In light of the recent movements in long-term bond yields, we seem to be at an inflexion point and the choice to invest in either bonds or equities can seem daunting. Compared to the last five years, none of the asset classes makes a compelling case for investment. Consequently, we have to choose to allocate capital where we feel the risk taken will be best rewarded, and the following points explain our choices.

1. **<u>Expect lower overall expected returns</u>:** As we can see in chart 19, we should expect lower returns across all asset classes. The main culprits for such an outcome are increasing yields, which will affect not only fixed income returns but equity valuations as well. However, fixed income assets should largely underperform stocks, which means that the security market line will be steeper and the free lunch from bonds is over. Therefore, investors should expect to be better compensated for the additional risks taken by investing in equities.

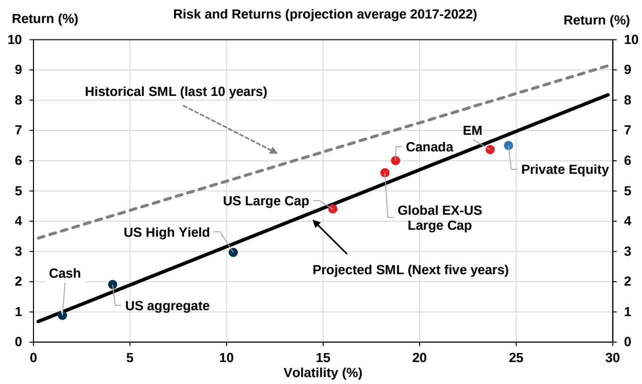
2. **<u>Equities look expensive, but bonds are in worse shape</u>:** P/E ratios are in the historical top of the range, which usually generates poor return prospects. However, the picture is different when we compare them to fixed income products (chart 20).

   We also cannot ignore the underlying response from the U.S. monetary and political authorities to the current environment. The Fed is in tightening mode, which is bad for fixed income products while Mr. Trump's fiscal policies, particularly the tax-reform portion, should give some breathing room for equity earnings going forward. Political and monetary policies do have an impact on returns and should be taken into account.

Bottom line: To generate interesting returns in the coming years, patience and diversification (geographic, credit and style) will be the key to success, especially when considering the rise of protectionism and political turmoil.

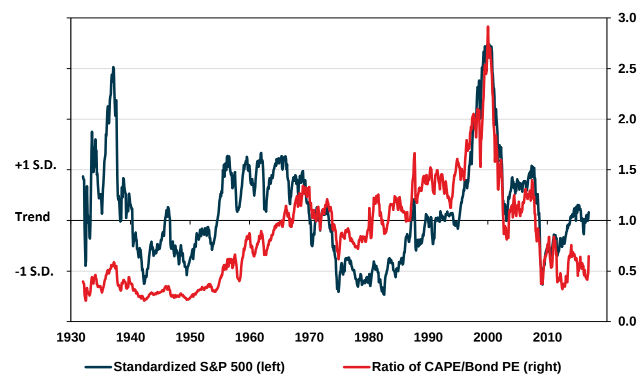
In the short term, we are maintaining a neutral stance in equities simply because we think they are at risk of a pullback. However, we stand ready to take an overweight position when the opportunity arises.

Less returns are projected



Source: Bloomberg
19

Equities look better compared to bonds



Source: Bloomberg
20