July 5, 2017

Asset Allocation Strategy

Looking for inflation

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Highlights

- The Federal Reserve got around weak inflation readings and hiked its key interest rates to 1.25% at the June FOMC meeting, in addition to opening the door to balance sheet reductions.
- In Canada, Governor Poloz made it pretty clear that despite soft inflation, the outlook was bright enough to start removing some policy accommodation.
- For our economics team, this means a July rate hike by the BoC is in the bag. As such, we are changing our current barbell row stance in bonds (a mix of short-term and longer-term bonds) for a shorter-than-benchmark duration in U.S. investment grade bonds.
- For crude oil, while less certain than in the weeks following the OPEC deal announcement, we are still expecting energy prices to firm up by the end of the year. Speculative positioning has now shifted to the point where we believe upside risk is more likely and, despite surprisingly resilient production from U.S. shale, a deficit in the global supply-and-demand picture is still expected in 2017.
- For equities, we believe the general backdrop is still sound, with most components of our macro models pointing toward an outperformance over bonds. However, due to both the current weak state of the NASDAQ index and the summer lull, we're maintaining neutral positioning.
- Attractive valuations and upside risk for oil prices favour energy stocks, while the prospect of rising interest rates should also be conducive to an outperformance in financials. This change should be beneficial to Canadian equities. Therefore, we're expecting the TSX index, whose price return was slightly negative after the first 6 months of the year, to rebound in the second half.

Table 1 Global Asset Allocation

Global Classes	−	Weights			+
Cash			Current	Previous	
Fixed Income		Previous	Current		
Equities			Current		
Fixed Income					
Federal		Current			
Investment Grade				Current	
High Yield (USD)			Current		
Non-Traditional FI				Current	
World Equities					
S&P/TSX			Previous	Current	
S&P 500 (USD)		Current			
Growth vs. Value			Current	Previous	
Large vs Small cap.				Current	
Defensives vs Cyclicals			Current		
MSCI EAFE (USD)				Current	
MSCI EM (USD)		Current			
Alternative Investments					
Currency Hedge			Previous	Current	
Commodities			Current		
Energy				Current	
Base Metals			Current		
Gold			Current		
Hedge Funds			Current		
Infrastructure			Current		

Source: Consulting Investment Committee

Current Allocation
Previous Month Allocation

Market review

Fixed income

- U.S. 10-year notes suffered following growing expectations that central banks would begin to curb their extensive stimulus measures. The yield on the 10-year benchmark gained nearly 20 bps throughout the last 5 days of June.
- Their Canadian counterparts followed suit after hawkish comments from its top two policymakers, with the 10-year benchmark surging 30 bps in one week.

Canadian equities

- The S&P/TSX closed the month 0.8% lower with Energy and Materials equities coming under pressure, offsetting gains in financials after Home Capital Group got a lifeline from Warren Buffett's Berkshire Hathaway.

U.S. equities

- Despite a tumultuous few days, the S&P 500 closed out June in positive territory, printing a modest 0.6% return.
- Divergence between sectors was significant in June, with losses in Utilities, Technology, Telecom, and Consumer stocks more than offset by a rally in Financials and Healthcare equities.
- Banks extended their rallies, as the Federal Reserve announced that every bank subjected to its annual stress test received approval for capital distribution.

Commodities

- Despite some help coming from a weaker USD later in the month, crude oil closed out June 4.7% lower at the mercy of speculators.
- Gold posted its first monthly decline of the year, dragged down by the sharp rise in bond yields.

Foreign exchange

- The loonie gained 4% against the greenback in June, pushed higher by the prospect of a rate hike this summer.
- The U.S. dollar remained on its 2017 bearish trend, reinforced by hawkish rhetoric coming from overseas central banks. For the quarter, the U.S. dollar index slid 4.7%, its steepest quarterly drop since Q3 2010.

Table 2 Market Returns

Asset classes	June	YTD	2016
Cash (3-month T-bills)	0.0%	0.2%	0.5%
Bonds (FTSE/TMX Ovr. Univ.)	**-1.2%**	**2.4%**	**1.7%**
FTSE/TMX Short term	-1.0%	0.2%	1.0%
FTSE/TMX Mid term	-2.3%	1.3%	1.6%
FTSE/TMX Long term	-0.7%	6.1%	2.5%
FTSE/TMX Government	-1.2%	2.2%	0.9%
Federal	-1.5%	0.8%	0.0%
Provinces	-1.0%	3.5%	1.8%
Municipales	-1.0%	3.6%	2.0%
FTSE/TMX Corporate	-1.0%	2.9%	3.7%
AA+	-1.0%	0.8%	2.0%
A	-0.8%	3.9%	3.6%
BBB	-1.1%	3.2%	5.1%
BoAML High-Yield (USD)	0.1%	4.9%	17.5%
Preferred shares	2.8%	8.7%	7.0%
Canadian Equities (S&P/TSX)	**-0.8%**	**0.7%**	**21.1%**
Energy	-4.0%	-13.3%	35.5%
Industrials	0.3%	11.7%	22.8%
Financials	2.5%	2.5%	24.1%
Materials	-4.0%	-0.7%	41.2%
Utilities	0.5%	10.1%	17.7%
Cons. Disc	-0.3%	12.2%	10.7%
Cons. Staples	-3.0%	4.4%	7.5%
Healthcare	13.6%	2.0%	-78.4%
IT	-4.3%	9.4%	5.2%
Telecom	-2.6%	7.6%	14.7%
REITs	-0.8%	6.0%	9.1%
S&P/TSX Small cap	0.5%	-4.1%	38.5%
US Equities (S&P500 / USD)	**0.6%**	**9.3%**	**12.0%**
Energy	-0.2%	-12.6%	27.4%
Industrials	1.4%	9.5%	18.9%
Financials	6.4%	6.9%	22.8%
Materials	1.9%	9.2%	16.7%
Utilities	-2.7%	8.8%	16.3%
Cons. Disc	-1.2%	11.0%	6.0%
Cons. Staples	-2.3%	8.0%	5.4%
Healthcare	4.6%	16.1%	-2.7%
IT	-2.7%	17.2%	13.8%
Telecom	-2.9%	-10.7%	23.5%
REITs	1.9%	6.4%	3.4%
Russell 2000 (USD)	3.3%	4.3%	19.5%
World eq. (MSCI ACWI)	**0.5%**	**11.8%**	**8.5%**
MSCI EAFE (USD)	-0.1%	14.2%	1.5%
MSCI EM (USD)	1.1%	18.6%	11.6%
Commodities (CRB index)	**2.9%**	**5.6%**	**12.9%**
WTI oil (US$/barrel)	-4.7%	-14.4%	44.8%
Gold (US$/ounce)	-1.9%	7.4%	9.0%
Copper (US$/tonne)	4.8%	7.3%	17.4%
Forex (DXY - US Dollar index)	**-1.3%**	**-6.4%**	**3.6%**
USD per EUR	1.4%	8.1%	-2.9%
CAD per USD	-4.0%	-3.5%	-2.9%

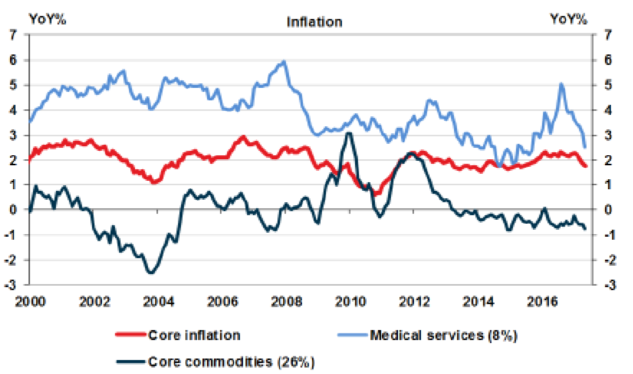
Source: Datastream 6/30/2017

Inflation, where are you?

If there is one consensus nowadays it is that, after years of very easy global monetary policy, inflation should be higher than it presently is. While that is doing little to quell the fight between hawks and doves, there is a whole list of reasons why it is currently weaker than expected and why it should eventually pick up.

As Chair Yellen put it in the press conference that followed the June 14 FOMC meeting, current low inflation readings in the United States are partly explained by "one-off reductions in certain categories of prices, such as wireless telephone services and prescription drugs (chart 1)." Base effects are also at play, as the huge unexpected monthly drop in March inflation will continue to be a drag on annual figures until the first months of next year.

One-off factors keeping inflation from running up

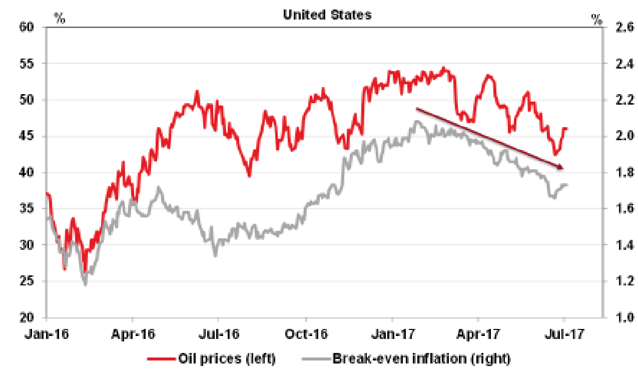


Source: Datastream
1

In the introductory speech of the June 27 ECB Forum on Central Banking Mario Draghi went a little further. He addressed an "unusual situation" described as economic growth above-trend, but with inflation dynamics more muted than one would expect on the basis of output gap estimates and historical patterns. His conclusion: monetary policy is working to build up reflationary pressures. However, the process is being slowed by a combination of external price shocks, more slack in the labour market, and the persistence of low inflation perpetuating these dynamics.

In terms of external shocks, the first thing that comes to mind is the collapse in oil prices that began at the end of 2014. While sharp drops in energy prices are often seen as having only a transitory effect on annual inflation, they can have a more persistent impact on underlying inflation generally through lower producer prices, if the trend is not reversed quickly. As such, the fact that oil prices have been on a downtrend since the start of the year is probably the main reason behind the recent fall in inflation expectations (chart 2).

Weak oil prices dragging down inflation expectations



Source: Datastream
2

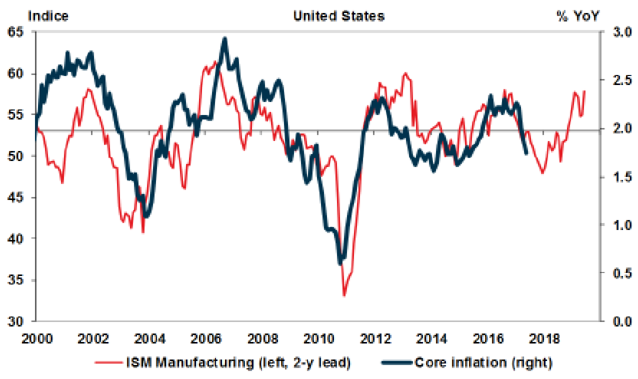
One thing is sure, however. Even with one-off adjustments in the price of telephone services or prescription drugs, the current state of energy prices is the direct result of supply-side adjustments and, therefore, central banks should look beyond it.

Instead, central banks are more preoccupied by economic slack, as there is historical evidence that closing the output gap – the difference between actual and potential production – leads to higher inflation. However, at its Annual Forum held June 25, the Bank for International Settlements suggested that this link had become "weak and elusive" for two main reasons. The first explanation put forth was that monetary policies were more credible at anchoring inflation expectations around target, and that tended to limit upswings in inflation even in overheating economies. The second reason was that it's difficult to get the true measure of slack due to globalization. With the integration of emerging market economies, the global effective labour force has been greatly enhanced over the years. Cheaper labour, competing on similar products, may have exerted downward pressure on the general price level in advanced economies.

Finally, there is this idea that low inflation feeds into weaker inflation and wage settling. Wage indexation, based on hindsight, is a good example of this.

All in all, there is some evidence that despite very accommodative monetary policies, inflation may take longer to return to historical norms (chart 3, next page). However, we continue to feel that inflation (a lagging indicator of the economic cycle) will pick up as the global expansion becomes more and more synchronous. For one thing, once supply-side reductions in prices of specific items are worked out of the calculations, base effects should become more favourable. Also, we view $40 per barrel as a bottom for oil prices and

Still some way to go before a pick-up



Source: Datastream
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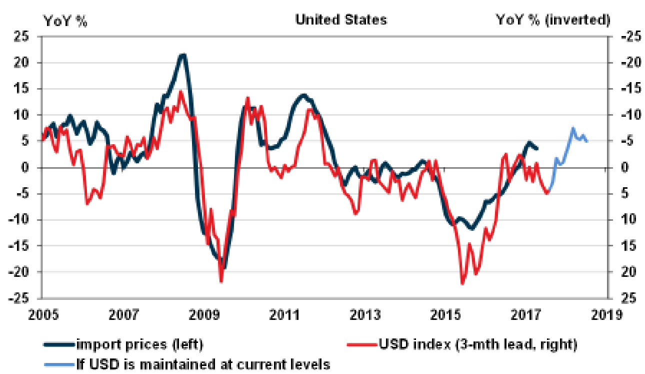
draws in inventories should lead to firmer prices until the end of the year (more on this in the commodities section). Finally, our call for a weaker greenback (see last month's edition for more details) should put upward pressure on U.S. import prices and have a ricochet effect on total inflation (chart 4).

Import prices could lead the way



Source: Datastream
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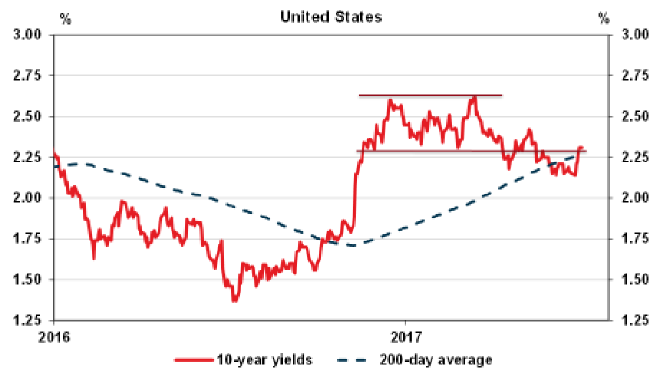
Fixed income: More rate hikes to come

With yields and durations at extreme levels, especially in Europe, a change in the landscape for inflation could have dire consequences for global bond markets. Just the hint that the ECB was getting ready (perhaps as soon as September) to taper its asset purchase program sent the market into a tailspin, following Draghi's speech at the Forum on central banking.

In the U.S., the Federal Reserve hiked key interest rates to 1.25% at the June FOMC meeting acknowledging it was looking past the current weakness in inflation – although keeping a keen eye monitoring the situation going forward. The Fed also opened the door to balance sheet reductions, by setting up limits to potential asset sales. In all likelihood, our best guess for the near future is a combination of one more hike and some tapering before the end of the year. Whichever comes first, both should be conducive to an upward move of the term structure (chart 5).

Yields should go higher with hawkish rhetoric



Source: Datastream
5

For its part, the Bank of Canada is now of the opinion that the insurance policy (50 bps of rate cuts) it took following the collapse in energy prices and the forest fires in Alberta is no longer needed. Governor Poloz made it pretty clear that despite soft inflation, the outlook was bright enough to start removing some policy accommodation. For our economics team, this means a July rate hike is in the bag.

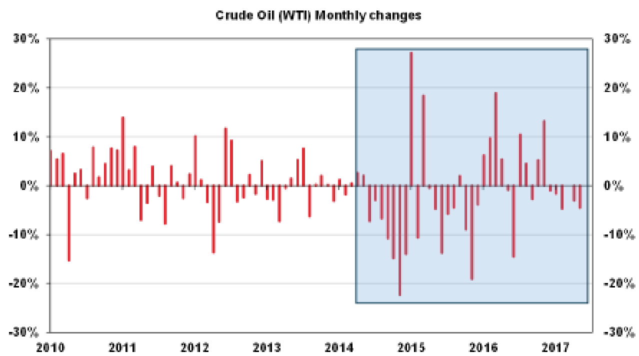
As a consequence, we are changing our current barbell row stance in bonds (a mix of short-term and longer-term bonds) for a shorter-than-benchmark duration in U.S. investment grade bonds. Fully hedged, this position should give us a 60 bps carry over Canadian benchmarks.

Commodities: Blocking out the noise in crude

Separating the fundamental picture from big price swings has always been a challenge in energy markets. The recent months have proven particularly difficult as headlines have had strong effects on the direction of markets. Since the downturn of mid-2014, we have witnessed uneven volatility, with cycles of relative calm followed by extreme bouts of volatility (chart 6, next page). The 13% drop from mid-May to mid-June is only the latest episode since February 2017 when 5 major moves occurred, each with an amplitude greater than 10%.

Speculators are the main culprits for such an outcome, as price gyrations seem to match positioning very closely on a short-term horizon (chart 7,next page). A herd-mentality stampede is usually a consequence of commodity markets in the process of rebalancing, as any small movements in anticipations materially change projections which quickly translate into new market views and trades.

A rebalancing market is usually more volatile...



Source: Datastream
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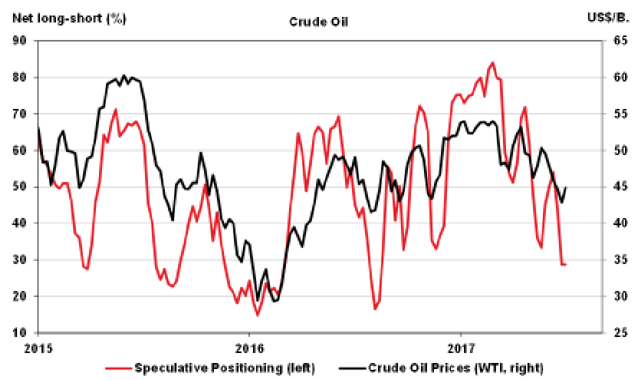
... especially when speculators take control



Source: Datastream
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Despite all the noise, we still believe energy levels should be higher by year-end. To be sure, we will closely monitor the following two factors, and reassess our view if any material changes occur:

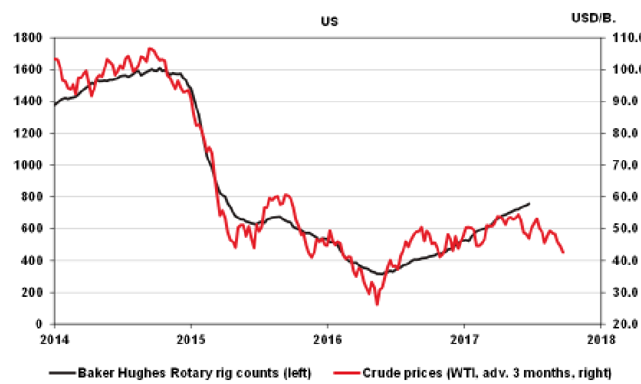
1- OPEC compliance and geopolitical risks

For now the OPEC + non-OPEC producers' adherence to the deal to cut 1.8 million barrels per day (bpd) is at more than 100%, which is unprecedented and exceeds all expectations analysts had before the deal was struck. However, this good news has been offset by surprisingly large increases in output of 300,000 bpd by Nigeria and Libya neither of whom are not constrained by the deal. Supply disruptions are notoriously hard to predict. Although they are currently on the low range of the spectrum, they are still adding to the impression of a supply glut. The likelihood is low that both of these countries will be able to sustain their current levels of production over a long period of time. Venezuela also tops the list of potential production shortfalls as the country's political and economic situation continues to deteriorate. While there is relative calm in the Middle East, the current lower prices are bound to increase geopolitical risk temperatures.

2- U.S. output and price response

As we argued before, the incremental barrel production now comes from U.S. shale oil and, consequently, the supply response to prices will be much quicker than in the past. Since the Q1 2016 lows, the ramp-up in U.S. activity has been fast and relentless, to the point of topping the effect of the OPEC cuts. However, there's a 3-month lag between drilling and prices (chart 8). This makes us think we are closing in on stabilization in U.S. output in the coming months, which should also act as a floor on prices at current levels. If crude were to fall another $5 to $10, we would expect U.S. activity to materially slow down.

We expect activity to slow down in the next months



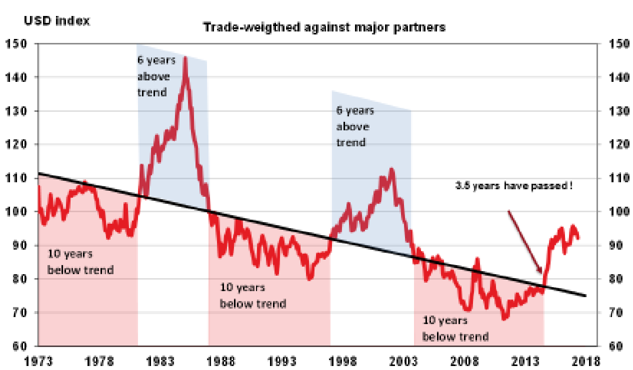
Source: Datastream
8

While less certain now than in the weeks following the OPEC deal announcement, we are still expecting energy prices to firm up by the end of the year. Speculative positioning has now shifted to the point where we believe upside risk is more likely and, despite surprisingly resilient production from U.S. shale, a deficit in the global supply-and-demand picture is still expected in 2017. There is also the potential for OPEC to do "whatever it takes" to rebalance the market and ramp up the effect of the deal either by cutting production more, or extending the deal beyond the March 2018 deadline.

Currencies: It's all about expectations, stupid!

As we put it last month, for the USD to reverse course the Fed is going to have to be a lot more aggressive than what is currently priced in by the markets. After a 6-year domination which took the greenback nearly 45% above its major partners – from the trough in 2011 to its peak in January 2017 – the sudden awakening by other central banks that extraordinary measures of policy accommodation are not needed anymore likely means the U.S. dollar has re-embarked on its secular downtrend (chart 9).

Greenback: the cycle seems to be repeating itself



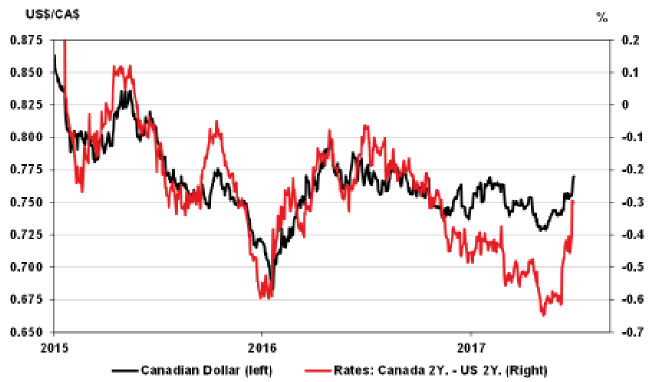
Source: Datastream
9

The Canadian dollar has already responded well to the changing environment breaking down its 5-year upward technical resistance line (chart 10 and 11). Until now, momentum has reached levels that have always been conducive to a reversal, and a short-term pull-back is possible. But, as the July rate hike is not yet fully priced in the markets, we feel there is more to come.

CAD: Breaking up the 5-year downtrend...

Source: Datastream
10

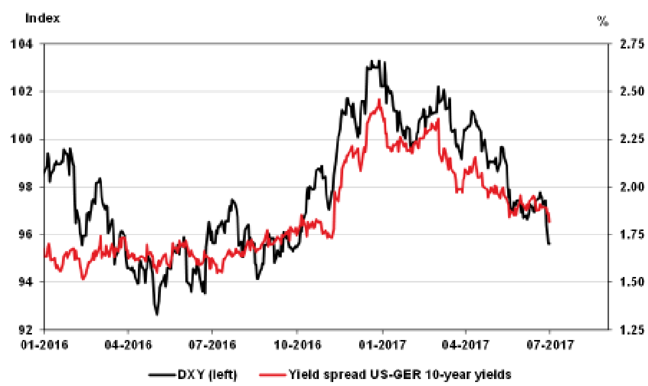
... as rate differentials have pushed the loonie around



Source: Datastream
11

Stay long on the euro as well. The European economy has run into all sorts of difficulties over the past decade or so, but is now turning the corner. With the possibility of the ECB tapering its bond purchases as soon as September, this will set the tone for a less accommodative stance through rate hikes starting in 2018 (chart 12).

USD will suffer as other central banks turn more hawkish



Source: Datastream
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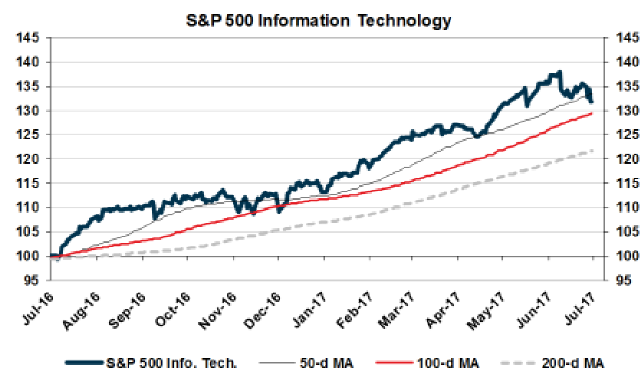
Equities: Techs hit the brakes as Canada gears up

Although information technology (IT) stocks have given back a little bit of their stellar performance lately (chart 13), the general backdrop for equities is still sound.

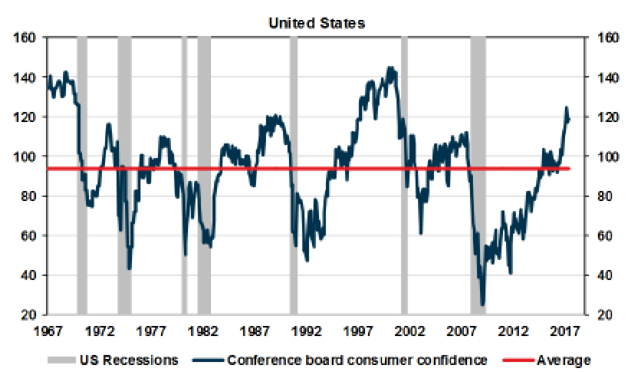
IT stocks are put the test!



Source: Datastream
13

For one, after a soft winter, U.S. economic activity accelerated in Q2. And prospects for the second half of the year are good with, above all, consumer confidence remaining high boosted by very low unemployment and rising wages (chart 14). Moreover, the ISM manufacturing index rebounded more strongly than expected to 57.8 in June, its highest level since August 2014.

Domestically, consumer confidence remains elevated

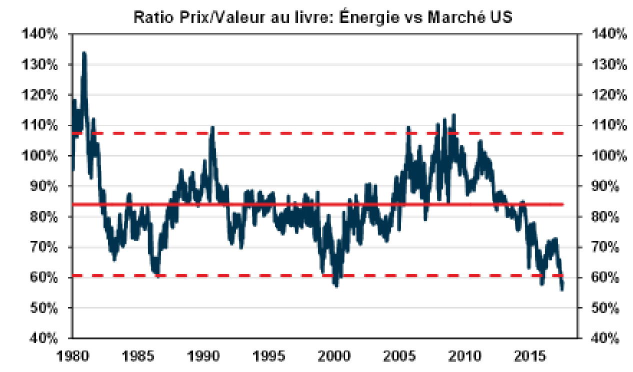


Source: Datastream
14

For another, earnings estimates for U.S. companies continue to point towards decent growth (+7.5%) for Q2, on year over year basis, despite topping margins. Strong growth is again seen in IT (+10.3%) and Financials (+6.1%), but the bulk of the acceleration should come again from energy stocks (+628%).

As such, we're expecting that that the huge gap between IT and energy stocks should finally narrow down to the benefit of the latter, as their price-to-book value is close to two standard deviation below historical trend (chart 15).

Energy is cheap relative to market

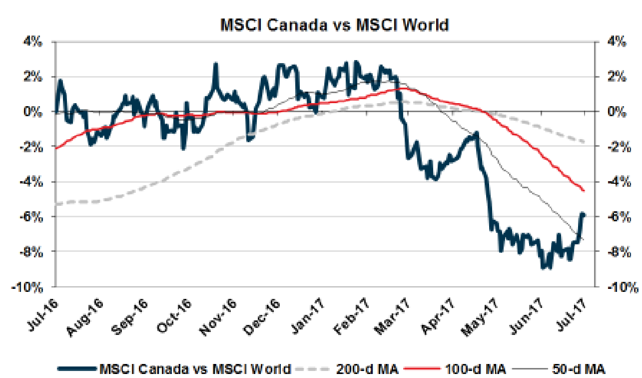


Source: Datastream
15

Other than energy stocks, the potential for rising interest rates should also be conducive to an outperformance in financials, which have also been lagging since the beginning of the year. If we're right, this would likely mean that the Growth outperformance over Value stocks should reverse.

This change in leadership should be beneficial to Canadian equities. Therefore, we're expecting the TSX index, whose price return was slightly negative after the first six months of the year, to rebound in the second half (chart 16).

Are Canadian equities making a turn?



Source: Datastream
16

All in all, most components of our macro models are pointing towards an outperformance of equities over bonds. However, due to the current weak state of the NASDAQ index, and the summer lull, we're maintaining a neutral positioning.