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Asset Allocation Strategy

Can risks trump the essential?

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Highlights

- What really matters is the economic cycle. Based on the expansion phase (that is, years of economic growth following the recovery period), the current cycle seems still short in the tooth. As such, equities should continue to outperform bonds in the medium to long-term horizon.
- In the shorter term however, things are not so clear. Surely, political risks have abated lately. Yet, we can't help but feel a sense of unease. With North Korea launching missiles, and China being back on the radar, our level of conviction is low.
- The minutes of the May FOMC meeting suggest the Fed is likely to increase interest rates at least twice more this year and will probably start reducing its balance sheet sometime in Q4 of 2017. As such, barring an external shock, the path of least resistance remains upward for bond yields until the end of the year. For the time being, however, in light of the risks to the outlook and the softness in inflation, we recommend maintaining a duration around benchmark with a preference for investment grade securities.
- In the U.S., for as long as IT "darlings" continue to do well, large-cap growth stocks should outperform value and smaller-cap stocks.
- Canadian equity market continues to lag its peers. Sagged by the recent fall in oil prices, the prospect of NAFTA renegotiations, the demise of Home Capital Group, and Moody's credit warning on Canadian banks, the TSX is about 3% below its February 21 all-time high. Although we feel a lot of bad news is priced in at current levels, we advise against jumping back pre-emptively into Canadian stocks.
- Our preference lies in Europe. Certainly, on a stand-alone basis, European markets are also expensive. But, they offer the best relative value versus U.S. markets as they stand at their lowest point since 1970 both on a local FX basis and on USD-adjusted terms.

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 ░

Market review

Fixed income

- U.S. 10-year notes rallied in the second half of May, as yields fell from a high of 2.41% to a low of 2.20%.
- Their Canadian counterparts witnessed a similar path to close out the month at 1.42%.

Canadian equities

- The energy sector continued to drag the overall index down. This marks the fourth month of negative out of five of negative performance in 2017.
- Industrials and IT are on a whole different path, maintaining their perfect score of monthly returns.

U.S. equities

- Negative news regarding Mr. Tump's involvement in a FBI investigation pushed the S&P 500 to gap lower, but nothing seems to stop the index the impact was erased in a mere 6 days to help the index eke out a +1.4% for the month.
- The U.S. IT sector continues to impress, not only is it the best performing sector for the year, but May caps the 6th month in a row of monthly performances higher than 1.5%
- The "Trump trade" is continuing to die a slow death as small caps, once again, underperformed their larger counterparts.

Commodities

- Seesaw action in crude oil as larger than expected inventory draws gave way to disappointment tied to an OPEC cut extension which didn't have any additional measures.
- Continued fears about tighter Chinese controls are pushing copper and other industrial metals lower.

Foreign exchange

- The loonie ignored crude oil woes and took advantage of a weak overall US dollar and positive economic numbers which reduced the timeframe for a potential hike from the Bank of Canada.
- The US dollar index finally fell victim to the "Trump trade" reversal as well as speculative length which finally converged back from extreme positioning.

Table 2 Market Returns

Asset classes	May	YTD	2016
Cash (3-month T-bills)	0.0%	0.2%	0.5%
Bonds (FTSE/TMX Ovr. Univ.)	**0.9%**	**3.6%**	**1.7%**
FTSE/TMX Short term	0.2%	1.2%	1.0%
FTSE/TMX Mid term	0.8%	3.7%	1.6%
FTSE/TMX Long term	1.8%	6.8%	2.5%
FTSE/TMX Government	1.0%	3.5%	0.9%
Federal	0.7%	2.3%	0.0%
Provinces	1.4%	4.6%	1.8%
Municipales	1.2%	4.7%	2.0%
FTSE/TMX Corporate	0.5%	3.9%	3.7%
AA+	0.1%	1.8%	2.0%
A	0.5%	4.8%	3.6%
BBB	0.5%	4.4%	5.1%
BoAML High-Yield (USD)	0.9%	4.8%	17.5%
Preferred shares	-1.7%	5.7%	7.0%
Canadian Equities (S&P/TSX)	**-1.3%**	**1.5%**	**21.1%**
Energy	-4.3%	-9.8%	35.5%
Industrials	3.3%	11.4%	22.8%
Financials	-2.0%	0.0%	24.1%
Materials	-2.2%	3.4%	41.2%
Utilities	2.0%	9.6%	17.7%
Cons. Disc	1.1%	12.6%	10.7%
Cons. Staples	-0.5%	7.6%	7.5%
Healthcare	7.6%	-10.2%	-78.4%
IT	3.2%	14.3%	5.2%
Telecom	-0.4%	10.5%	14.7%
REITs	0.2%	6.8%	9.1%
S&P/TSX Small cap	-4.0%	-4.6%	38.5%
US Equities (S&P500 / USD)	**1.4%**	**8.7%**	**12.0%**
Energy	-3.4%	-12.5%	27.4%
Industrials	1.5%	8.0%	18.9%
Financials	-1.2%	0.4%	22.8%
Materials	-0.1%	7.2%	16.7%
Utilities	4.2%	11.8%	16.3%
Cons. Disc	1.1%	12.3%	6.0%
Cons. Staples	2.9%	10.5%	5.4%
Healthcare	0.8%	10.9%	-2.7%
IT	4.4%	20.5%	13.8%
Telecom	-1.0%	-8.1%	23.5%
REITs	0.7%	4.4%	3.4%
Russell 2000 (USD)	-2.2%	1.0%	19.5%
World eq. (MSCI ACWI)	**2.3%**	**11.3%**	**8.5%**
MSCI EAFE (USD)	3.8%	14.4%	1.5%
MSCI EM (USD)	3.0%	17.3%	11.6%
Commodities (CRB index)	**2.3%**	**2.6%**	**12.9%**
WTI oil (US$/barrel)	-2.1%	-10.2%	44.8%
Gold (US$/ounce)	0.0%	9.5%	9.0%
Copper (US$/tonne)	-0.9%	2.4%	17.4%
Forex (DXY - US Dollar index)	**-2.2%**	**-5.2%**	**3.6%**
USD per EUR	3.3%	6.6%	-2.9%
CAD per USD	-1.1%	0.5%	-2.9%

Source: Datastream 5/31/2017

The economic cycle is ultimately what matters

While political events can provide markets the needed spark to take some of the froth out of overbought conditions, more than often, their lasting actions are quite low. Investors (yours truly included) have learned this the hard way, starting with the Brexit vote in June 2016 and the election of Donald Trump in November of the same year. Both events were seen as having high negative market impact with low probability of occurrence. As we now know, the complete opposite happened. In the midst of a pick-up in global activity and the stabilization of oil prices, earnings gathered momentum and supported a strong equity rebound.

With Donald Trump making the headlines every day, it is still hard to focus on things that really matter. Again, it turns out the firing of the FBI director James Comey was a non-event, as well as when he later came out with allegations that Trump asked him to put on the back burner his investigation into the former National Security Adviser Michael Flynn. Markets have since recouped more than their losses, and most of them now stand at record levels (Chart 1).

Buy the dip mentality

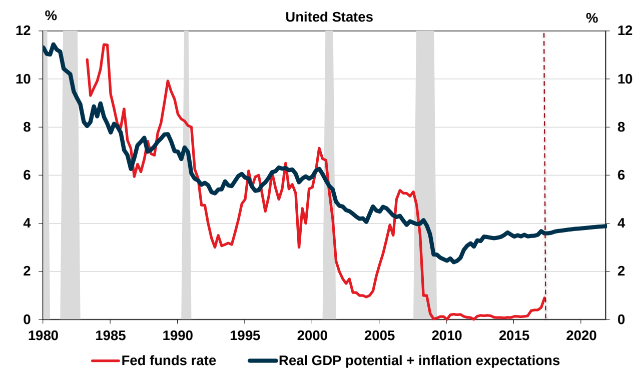
Source: Datastream

1

The lesson taken from all of this is that while markets don't like uncertainty, they are ready to move past any realized outcome, unless it involves an immediate impact on growth. The reality is that Trump has very little to do with the ongoing economic activity or the earnings season. And even though the recent events put in question his ability to have his fiscal measures approved integrally by the U.S. Congress, some form of expansionary measures will happen, and these are seen as market supportive.

In the end, what really matters is the economic cycle. In other words, equity market corrections don't occur unless you get to a point where monetary policy becomes restrictive and causes a recession. By our measure, we are far from there. Sure, the Federal Reserve is in tightening mode (see the section on fixed income for an update), but monetary policy remains very accommodative at current levels, even after considering that potential GDP growth and inflation expectations are probably lower than in the past (Chart 2).

Still far from restrictive territory

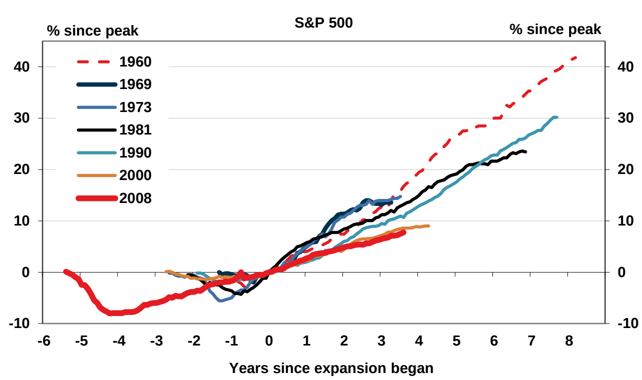


Source: Datastream

2

Basically, what this means is that the economic cycle has further to run. In fact, based on the expansion phase (that is, years of economic growth following the recovery period), the current cycle seems rather short in the tooth (Chart 3). As such, equities should continue to outperform bonds in the medium to long-term horizon.

Post-recovery expansion still young



Source: Datastream

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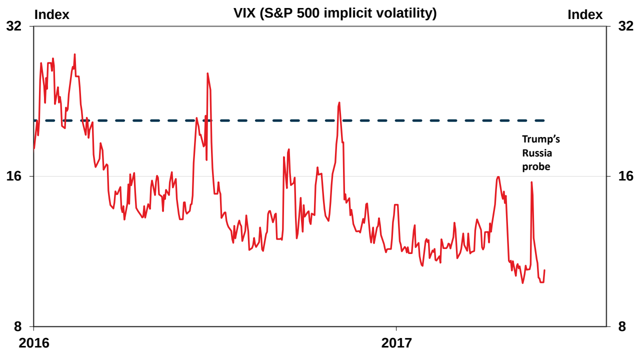
Risks to the baseline scenario: Sense of unease

Political risks have abated lately: Macron won the French Presidential election; the partial election in Germany was a clear win for Chancellor Merkel's party and augurs well for national polls in September; and Trump, for whom the markets seems to be forgiving any of his wrongdoings (Chart 4), is unlikely to be impeached unless Democrats win back the House of Representatives in late 2018.

Volatility back to the lows of 1993



Source: Datastream
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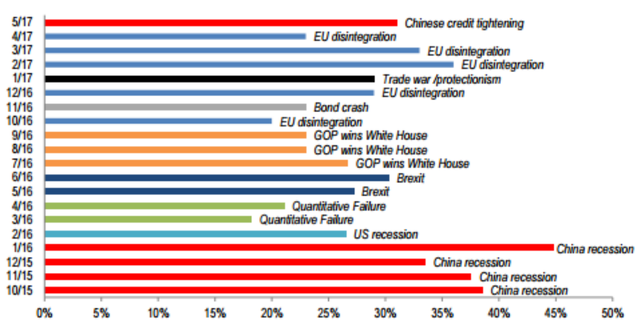
However, some geopolitical risks persist, North Korea launching missiles and bragging about having nuclear capabilities is not going to be ignored by U.S. military forces for very long. China is also back on the radar. According to the Fund Manager Survey, after the rise of populism in Europe in April, Chinese credit tightening was perceived as the number one risk that could derail global expansion in May (Chart 5).

China back on top of managers' list of risks



Source: BoAML Global Fund Manager Survey
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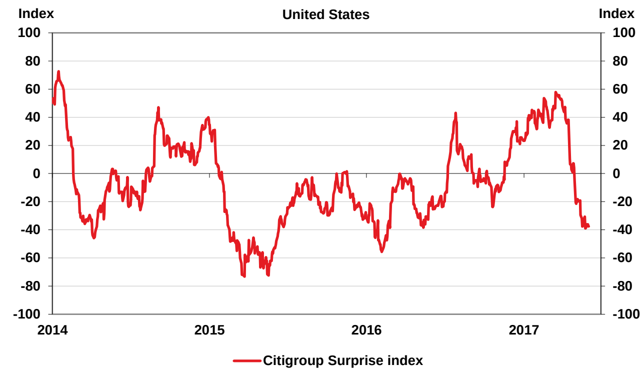
For now, things remain quiet, with the yuan even gaining traction lately. But a policy-led slowdown in China and another slew of lower-than-expected data from the U.S. (Chart 6) could be reminiscent of early 2016, when equity markets dropped more than 10%.

All in all, this goes to say that we favour equities, but our level of conviction is low (more on this in the equity section).

Fixed income: Slightly below benchmark duration

Although bonds will continue to be your best bet against any equity market pullback, the reality is that expected returns on

Are expectations still too high in the USA?

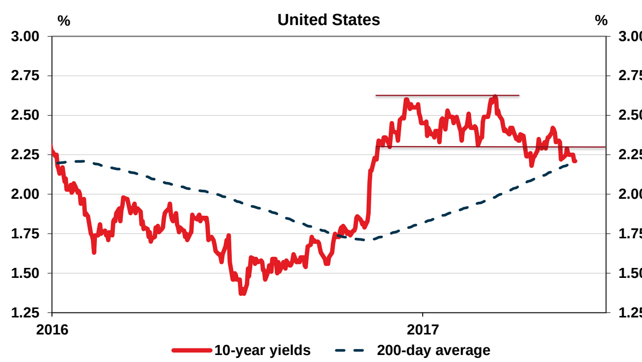


Source: Datastream
6

government securities based on current yield to maturity is poor.

After hovering between 2.3% and 2.6% over the first three months of the year, U.S. 10-year notes rallied somewhat following weaker-than-expected economic activity and inflation data (Chart 7), and some waning of investor optimism regarding prospects for expansionary fiscal policies.

Bond yieds breaking lower



Source: Datastream
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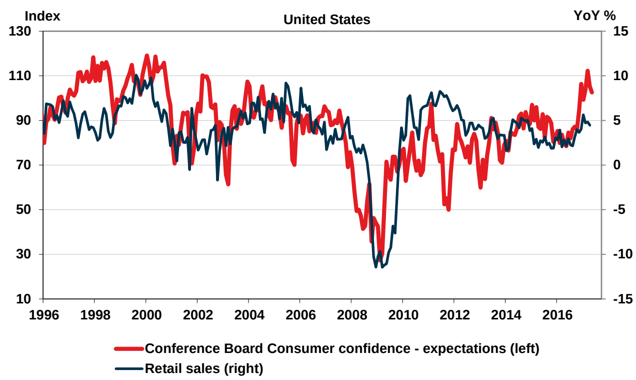
However, that shouldn't be sufficient to derail the Fed's willingness to hike interest rates as early as June 14. To that effect, some clarity was provided last week in the minutes of the May FOMC meeting. One of the consistent themes was the Fed's view that the 2017 Q1 economic softness was largely transitory. Of note, consumer spending was surprisingly weak during the period reflecting low sales on energy services, due to an unusually mild winter, and on motor vehicles, from an unsustainable pace in the Q4 of 2016. But growth is expected to pick up in the spring, in light of recent strong job momentum, gains in real disposable income, and a high level of consumer confidence (chart 8).

Consumer confidence points to stronger sales



Source: Datastream
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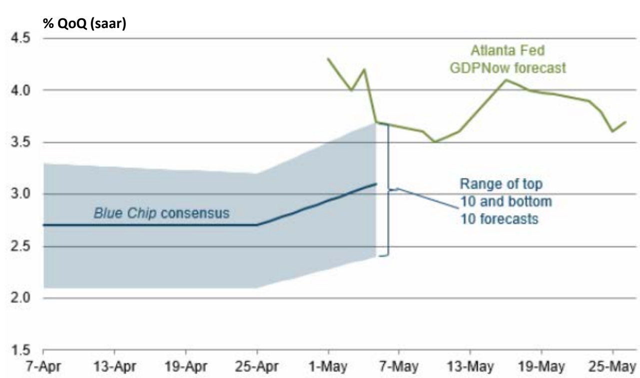
This is in line with timely measures of economic activity such as GDPNow from the Atlanta Fed which points to a rebound close to 4%, at an annualized rate, for Q2 of 2017 (Chart 9).

GDP growth should pick up nicely in Q2 2017

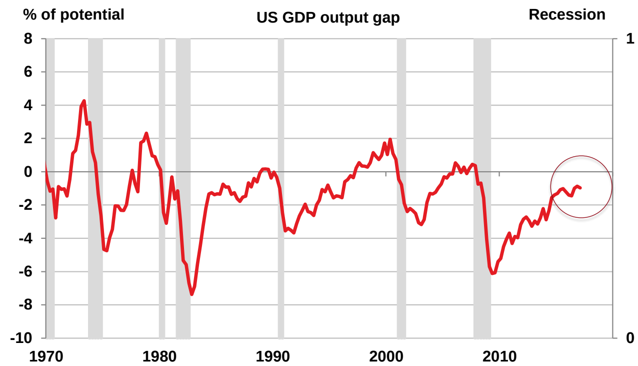


Source: Atlanta Fed GDPNow
9

All in all, the Fed continues to project that real GDP should expand at a modestly faster pace than potential output from 2017 through 2019, supported in part by the assumption that fiscal policy would become more expansionary in the coming years. This would help close the output gap and contribute to inflationary pressure going forward (chart 10).

For now however, inflation is still low and should continue to exert downward pressure on nominal yields (chart 11). The minutes specifically attributed some of the slowdown to idiosyncratic factors, though there still seemed to be some debate regarding the extent of the tightness of the labour market.

Output gap: Almost there!



Source: Datastream
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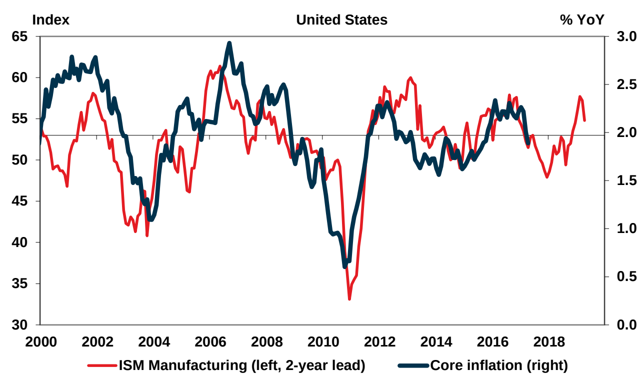
Weak underlying inflation could get weaker



Source: Datastream
11

There was no concerted push to tighten at the May meeting, however the minutes noted that most participants judged that, if economic information came in about in line with their expectations, it would "soon" be appropriate to raise rates again. If you read between the lines, it's going to take a whole lot of bad news to prevent the Fed from raising rates in June.

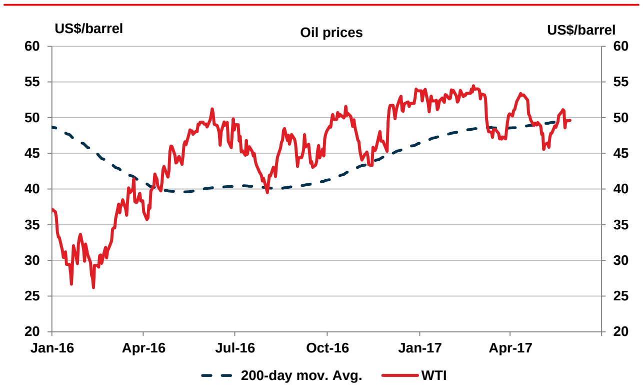
Finally, as expected, the minutes featured more colour on looming changes in the Fed's balance sheet reinvestment policy. They noted that nearly all policymakers expressed a favourable view of the staff briefing focused on reducing holdings in a gradual and predictable manner. Under such a program, the Fed would announce a set of gradually increasing caps on the dollar amounts of Treasury and Agency securities that would be allowed to run off each month.

The bottom line is that the Fed is likely to increase interest rates at least twice more this year and will probably start reducing its balance sheet sometime in Q4 of 2017. As such, barring an external shock, the path of least resistance remains upward for bond yields until the end of the year. For the time being, we recommend maintaining a duration slightly below the benchmark with a preference for investment grade securities.

Commodities: Fundamentals vs. risks

While the near-5%-drop in oil prices (Chart 12) after OPEC members last week announced a nine-month extension of their deal may seem puzzling to some, we must remember that crude oil follows the same expectations game as other financial assets. A lengthening of their term was nearly a certainty. But some were hoping for cuts with a little more bite, such as caps on Libya or Nigeria, or a greater overall activity reduction than the initial deal. Saudi Arabia said the extension should rebalance the market by the end of the year, which basically implies that they didn't see the need for additional measures.

Oil prices

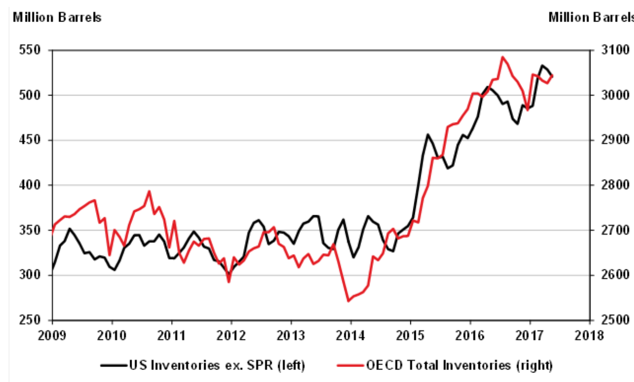


Source: Datastream
12

Speculators don't seem to agree. Controlling cartel member output may be feasible, but U.S. shale production is a whole other beast that reacts to only one factor: prices. The U.S. ramp-up potential will keep the upside limited, while Saudi and Russian promising to do "whatever it takes" to normalize inventories will act as a support. We expect speculators to eventually test OPEC members' resolve down the road as worldwide stocks remain the elephant in the room – and they are massive (chart 13).

Now that the announcement is behind us, full compliance for members is still expected, and this should be reflected in inventory draws worldwide. Should these be lower than what was initially expected, the first culprit would be production cheating resulting in a swift downturn for crude. The disappointment regarding the failure to implement additional measures in the agreement underlines the market's fears about the potential for further production from the

Oil inventories are still very elevated



Source: Datastream
13

unconstrained participants such as Libya, Nigeria and U.S. shale. If those concerns finally materialize, additional cuts or another extension would be needed for the market to rebalance. For now, we are walking a tightrope – and the question remains whether or not OPEC can manage the balancing act.

In America, Mr. Trump's announcement that he plans to reduce by half the size of the U.S. strategic Petroleum Reserve (SPR) by 2027 was met with a shrug. The headline may be impressive but it is still uncertain if this measure will be adopted. And even if it were to pass, the effects would not begin until 2018. Another point to consider is that those withdrawals are back-loaded, with the bulk of outflows only starting in 2021 which is too far down the road to have an immediate impact on prices.

By summing all those developments up together, our scenario of a long and gradual price appreciation is still valid as the positive offsets the negative, and actors in the space have incentive for stability going forward.

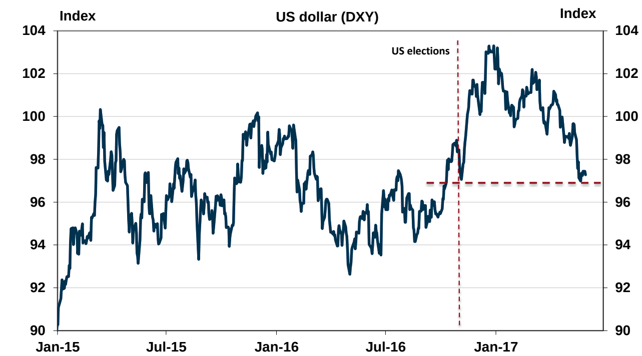
Currencies: Proxies for political risk and trade wars

The USD has also suffered collateral damage of "Trump trade gone wrong." Since the beginning of the year, the dollar index has lost close to 5% of its value against its major trading partners, falling back to the level prevalent before the U.S. Presidential election (Chart 14).

Coincidentally, the reversal of what was perceived as "the" consensus trade of the past few years (Chart 15) was matched by a turnover in net long USD positions from extreme levels, a condition suggesting the currency may have peaked (Chart 16).

The way we see things, with monetary tightening well embedded in market expectations, one of two things needs to happen for the currency to resume its uptrend: either the Fed will be more aggressive, or the ECB will postpone the tapering of its monetary purchases to later in 2018. A pre-condition for the former would be for the Fed to start hiking interest rates right at the June 14 meeting. As things look a little bit overdone for the USD, this would likely be conducive to a short-term rebound.

USD: Back to square one



Source: Datastream
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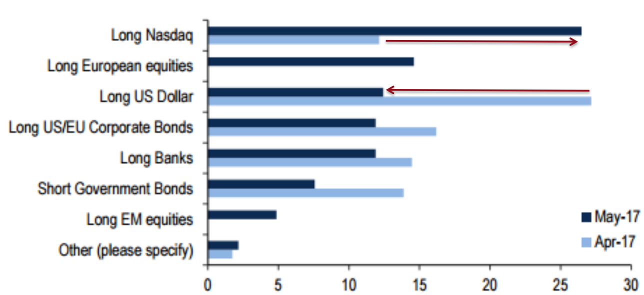
In tech stocks, out USD



Source: BoAML Global Fund Manager Survey
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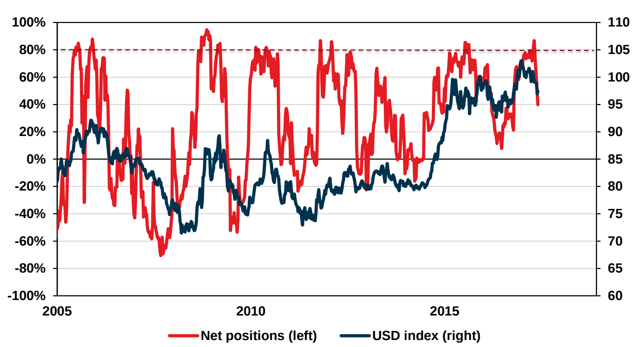
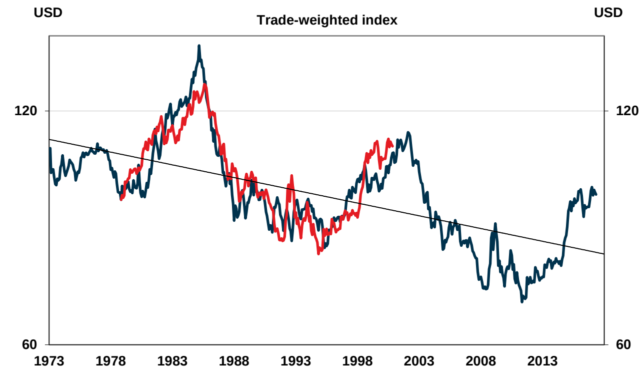
Speculators unwinding net longs



Source: Datastream
16

Historically, however, when the Fed starts a new cycle of monetary tightening, U.S. dollar strength is pretty much in its final innings (Chart 17). Therefore, we wouldn't be surprise to see the Euro trough around current levels, and gain momentum later on.

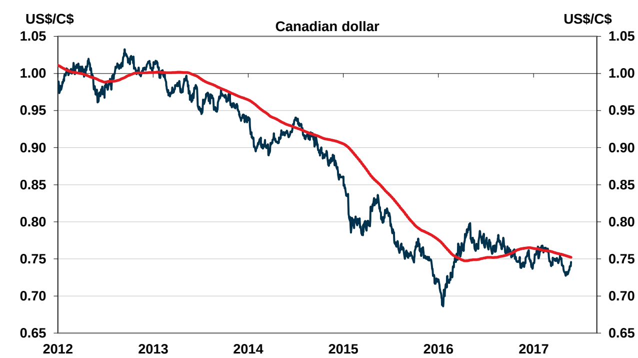
USD appreciation is getting long in the tooth



Source: Datastream
17

For its part, the Canadian dollar has moved back into the 1.30-1.35C$/US$ range of November of last year, following stronger economic data, a less dovish stance on the part of the Bank of Canada, USD weakness, and a pick-up in oil prices. Things may continue to evolve positively for the loonie as markets reassess the potential timing of the first rate hike in Canada. But, the immediate trend remains negative for the currency and until we get a clearer view on oil prices developments, our bet is the currency will stay range-bound (Chart 18).

CAD: Downward pressure until the BoC turns bullish



Source: Datastream
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Equities: Europe on relative basis

The S&P 500 reporting season was positive on most fronts in the first quarter of 2017. Bottom-up annual growth in sales was +7.4% with a 62% beat, while that of earnings was close to +15% with a 75% beat (Chart 19). The strongest contribution to earnings growth came from the energy sector, which benefitted from a sharp increase in oil prices over the period, followed by the information technology (IT) and banking sectors.

S&P 500 Earnings summary

	Q1 Earnings Summary				Surprise	YoY Growth
Identifier	% Reported	% Beat	% Met	% Missed	Reported Actual	Reported Actual
All Sectors (505)	**497 / 505**	**75%**	**7%**	**18%**	**6.0%**	**15.4%**
Energy (34)	34 / 34	65%	6%	29%	24.9%	750.4%
Materials (25)	25 / 25	76%	4%	20%	6.2%	19.3%
Industrials (67)	67 / 67	79%	4%	16%	9.5%	4.1%
Consumer Discretionary (85)	83 / 85	75%	7%	18%	9.6%	6.5%
Consumer Staples (37)	34 / 37	50%	12%	38%	1.1%	5.6%
Health Care (60)	59 / 60	85%	2%	14%	4.8%	7.1%
Financials (65)	65 / 65	85%	3%	12%	5.0%	21.6%
Information Technology (69)	67 / 69	88%	7%	4%	6.1%	19.1%
Telecommunication Services (4)	4 / 4	0%	50%	50%	-0.5%	-5.0%
Utilities (28)	28 / 28	75%	7%	18%	5.7%	2.7%
Real Estate (31)	31 / 31	55%	16%	29%	1.1%	2.7%

Source: Datastream

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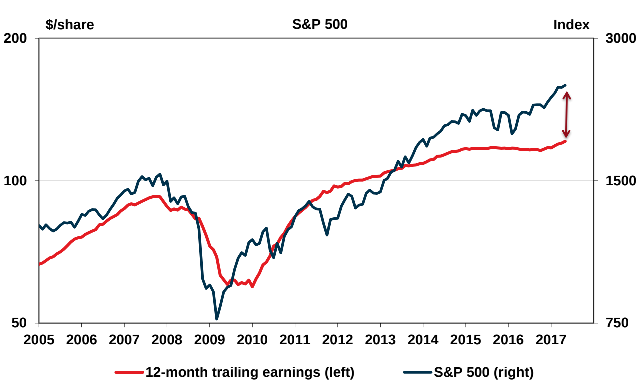
With such strong performance, it is easier to understand why U.S. equity markets were able to navigate through murky waters and reach new highs recently. However, drilling down to the details shows that the overall rally in the S&P 500 is not signalling that there is without a doubt nothing at all to worry about.

Firstly, as indicated previously, earnings have rebounded heftily over the past year. But they pretty much have stalled over a three year period while equity prices have boomed, putting valuations on the expensive side (Chart 20).

Earnings: Mind the gap!



Source: Datastream

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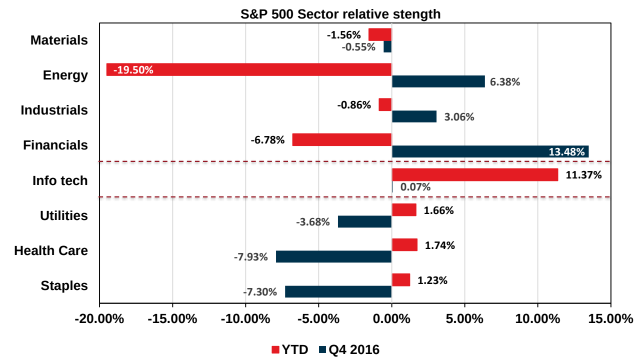
Secondly, the rally has been mostly assumed by defensive sectors since the beginning of the year. Staples, Health Care and Utilities stocks have all outperformed the S&P 500 index, while more cyclical sectors such as Energy, Materials, Industrials and Financials have lagged. This is a complete reversal from what was perceived as the Trump trade in the last quarter of 2016 (Chart 21).

Rally mostly defensive (except for IT) year-to-date



Source: Datastream

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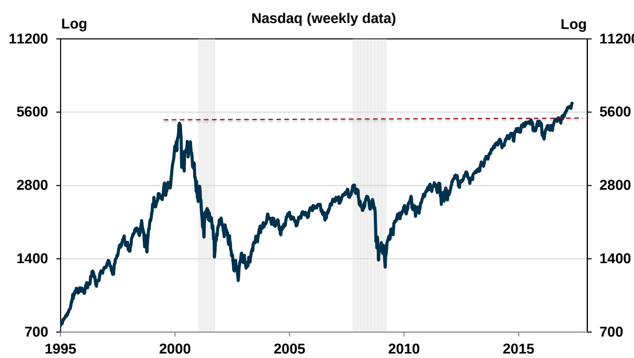
The only exception to this is the IT sector which has become the crowd's favourite. This is best explained by NASDAQ where almost 60% of the index is in IT stocks. After rolling over at the end of 2015 at levels marking a double top from its previous 17-year-old record, it has recently soared to new highs (Chart 22).

NASDAQ finally higher… after 17 years!



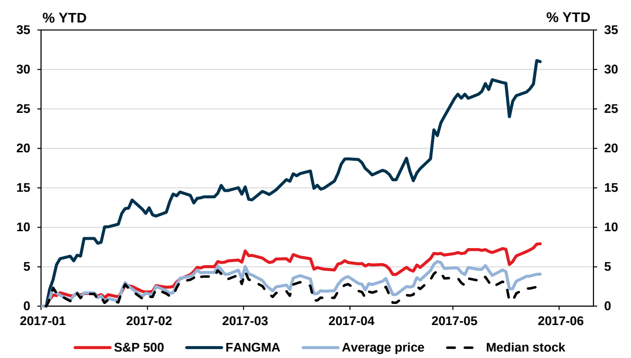
Source: Datastream

22

But again, this outperformance is the reflection of a handful of stocks showing that market breadth is currently rather poor. Similarly to 2015, the super heavyweights (Facebook, Amazon, Google, Microsoft and Apple) and the highflyer (Netflix) are up the most on an equally-weighted aggregated basis, and are pulling the NASDAQ and S&P 500 indices upward. This comes in sharp contrast to the arithmetic average performance of the index or that of the geometric mean (Chart 23 next page).

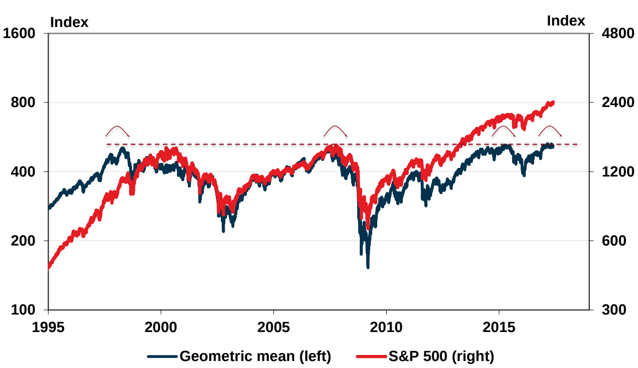
To that effect, it is worth noting that the median stock is, once again, hitting the ceiling on what appears to be its highest level since 2000. This marks a quadruple top for an indicator which has been liable for rolling over in advance of the broad market over the past 30 years (Chart 24).

Excluding FANGMA stocks there's been no real progress



Source: Datastream
23

Will the median stock call the shot again?

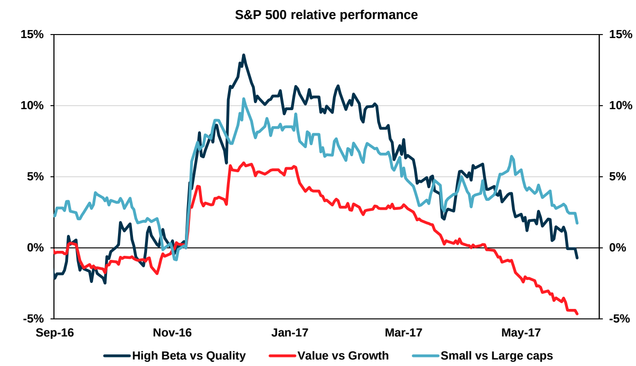


Source: Datastream
24

Frankly, while markets look toppish and valuations expensive, there is nothing preventing them from going higher. The end of the 90s is a good reminder of this. However, our macro models, based on manufacturing activity, jobless claims, consumer confidence and market trends, while continuing to point towards further equity gains, suggest a more prudent approach. Therefore, we recommend a slight overweight in equities compared to benchmark, and advocate buying only on dips.

In the U.S., for as long as IT "darlings" continue to do well, large-cap growth stocks should outperform value and smaller-cap stocks (Chart 25). The immediate trend is up, and it should remain so until oil prices firm up or interest rate margins widen, which would be beneficial, respectively, to a rebound in energy and financial stocks, two sectors heavily tilted on the "value" side.

Quality large-cap growth stocks are leading the way

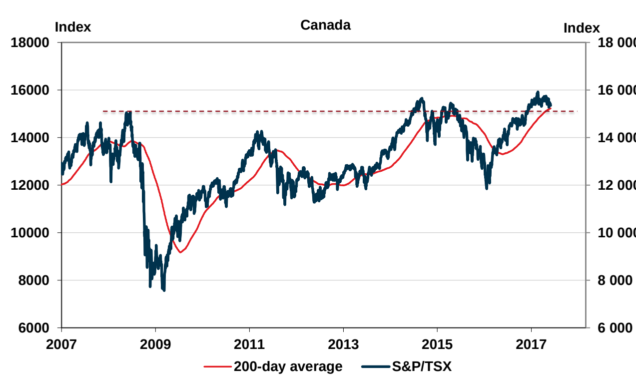


Source: Datastream
25

Geographically speaking, the Canadian equity market continues to lag its peers. Sagged by the recent fall in oil prices, the prospect of NAFTA renegotiations, the demise of Home Capital Group, Moody's credit warning on Canadian banks, and the rising debt burden of consumers in the midst of sharp increase in home prices in Vancouver and Toronto, the TSX is about 3% below its February 21 all-time high.

Although we feel a lot of bad news is priced in at current levels, we advise against jumping back pre-emptively into Canadian stocks. The immediate trend of the index is rolling over, and while the 200-day moving average should act as an important technical support, investors are likely to retest the peak of 2008 – a level which three times over the last three years the TSX has had difficulty moving past (Chart 26). In the dull summer months, perhaps it's wise to stay on the side lines.

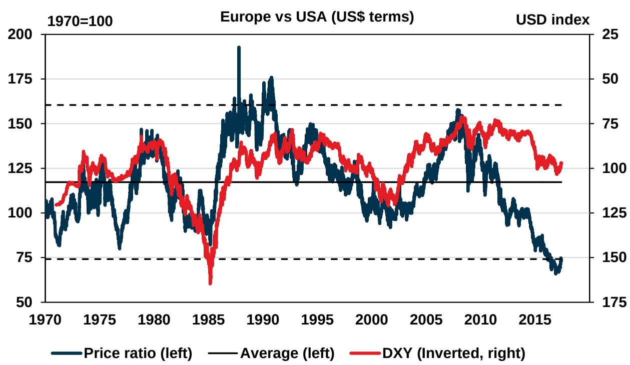
TSX: Looking for support!



Source: Datastream
26

Our preference lies in Europe. Certainly, on a stand-alone basis, European markets are also expensive. But, they offer the best relative value versus U.S. markets as they stand at their lowest point since 1970 both on a local FX basis and on USD-adjusted terms (Chart 27).

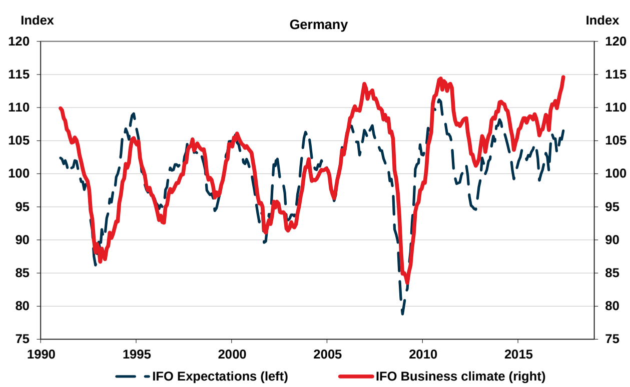
Europe: Good relative play



Source: Datastream
27

Although potential growth remains low in Europe, growth expectations may well be exceeded this year as business activity is booming in many parts of the continent, particularly so in Germany (Chart 28).

IFO's business climate at the highest level ever



Source: Datastream
28