INVESTING

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Asset Allocation Strategy

The good, the bad and the ugly

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Highlights

- The likelihood for tightening (now that March is "live") increased from 27% to over 80% since the beginning of February. While a hike in March may have a limited impact, an increase in the dots from the summary of economic projections tied to the decision would move the dial much more as it would signal to investors that FOMC members plan to tighten three times 2017.
- We still believe most yields will have a tendency to appreciate by the end of the year. Therefore, we suggest treading cautiously on the duration-side and investing in shorter-term securities.
- Investing in equities has now become a question of optics. The class may look attractive or not depending on the lens used to analyze them. They are certainly exhibiting a curious mix of *the good, the bad,* and *the ugly*.
- The good: PMI figures are still going strong and are deeply in expansionary mode. Consequently, equities are also the best asset class to benefit from an accelerating growth environment. This is especially true when other investment possibilities such as fixed income, seem to offer lower potential returns.
- The bad: If policies set forth by the U.S. administration have less amplitude than what was previously announced, equities should suffer as we would expect that the reasons for appreciation would be just as valid the other way around.
- The ugly: The RSI briefly crossed over 80, a first since… 1996! Price volatility is also eerily low as the realized three-month standard-deviation is now standing at 6.3%, a level close to what we witnessed prior to the financial crisis. Fundamentally, while a 10%+ earnings growth is expected for 2017, we are left wondering how much of it is already priced in when the 12-month forward PE for the S&P 500 is now registering 17.8.

Table 1 **Global Asset Allocation**

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

Source: Consulting Investment Committee

Current Allocation
Previous Month Allocation

NATIONAL BANK

Market review

Fixed income

- A seesaw action was evident in fixed income markets as U.S. 10-year yields hovered between 2.35% and 2.50% (which now seem like technical levels on the downside and upside).
- Their Canadian counterparts witnessed the same action, the only difference being the range level that is from 1.60% and 1.80%.

Canadian equities

- Early cyclicals were the main driver of performance in February as all three sectors (financials, consumer discretionary, and technology) contributed to the index performance.
- On the downside, the high weightings in energy and materials offset the gains from the other sectors.
- Oil producers' performance also explains the main difference between the S&P/TSX and the S&P 500, as they are now down 6.6% from the beginning of the year.
- It's the same situation for gold – the precious metal was up,
  but gold mines still recorded -2.6% for the month.

U.S. equities

- There was unrelenting price action in February with the S&P 500 only recording 4 negative days over the month.
- Broad-based gains were noted across all sectors, except energy and telecom, with Healthcare leading the pack.
- Except for energy and telecom, most sectors have recorded performances over 4.5% year-to-date, which is a testament to the impressive breadth of market we have witnessed in recent months.

Commodities

- Crude oil is slowly grinding upwards as OPEC announced record compliance with the cuts. However, inventories on the rise in the continental U.S. put a lid on price appreciation.
- Gold is benefitting from flows in the ETF markets with strong inflows from retail investors.

Foreign exchange

- We are seeing strong performance for the greenback following a more hawkish tone from the Fed and increasing probabilities of a hike for the March meeting.
- The loonie is still stuck in a range between $1.30 and $1.33 as investors wait for clarity regarding NAFTA negotiations.

Table 2 **Market total returns**

Asset classes	February	YTD	2016
Cash (3-month T-bills)	0.0%	0.1%	0.5%
Bonds (FTSE/TMX Ovr. Univ.)	**1.0%**	**0.8%**	**1.7%**
FTSE/TMX Short term	0.3%	0.5%	1.0%
FTSE/TMX Mid term	1.1%	1.3%	1.6%
FTSE/TMX Long term	1.8%	0.9%	2.5%
FTSE/TMX Government	0.9%	0.6%	0.9%
Federal	0.6%	0.4%	0.0%
Provinces	1.3%	0.8%	1.8%
Municipales	1.3%	1.0%	2.0%
FTSE/TMX Corporate	1.0%	1.4%	3.7%
AA+	0.5%	0.9%	2.0%
A	1.2%	1.4%	3.6%
BBB	1.2%	1.8%	5.1%
BoAML High-Yield (USD)	1.6%	2.9%	17.5%
Preferred shares	1.5%	5.6%	7.0%
Canada (S&P/TSX)	**0.2%**	**1.1%**	**21.1%**
Energy	-1.2%	-6.6%	35.5%
Industrials	1.6%	2.1%	22.8%
Financials	1.2%	3.6%	24.1%
Materials	-3.7%	5.2%	41.2%
Utilities	0.6%	2.0%	17.7%
Cons. Disc	3.7%	3.1%	10.7%
Cons. Staples	-0.6%	-2.0%	7.5%
Healthcare	4.9%	1.3%	-78.4%
IT	1.3%	1.6%	5.2%
Telecom	-0.9%	1.8%	14.7%
REITs	5.0%	4.8%	9.1%
S&P/TSX Small cap	-0.1%	0.5%	38.5%
US (S&P500 / USD)	**4.0%**	**5.9%**	**12.0%**
Energy	-2.2%	-5.7%	27.4%
Industrials	3.8%	5.3%	18.9%
Financials	5.2%	5.4%	22.8%
Materials	0.7%	5.4%	16.7%
Utilities	5.3%	6.6%	16.3%
Cons. Disc	1.9%	6.3%	6.0%
Cons. Staples	5.0%	6.7%	5.4%
Healthcare	6.4%	8.8%	-2.7%
IT	5.1%	9.8%	13.8%
Telecom	-0.4%	-2.9%	23.5%
REITs	4.7%	4.6%	3.4%
Russell 2000 (USD)	1.8%	2.2%	19.5%
World eq. (MSCI ACWI / USD)	**2.8%**	**5.7%**	**8.5%**
MSCI EAFE (USD)	1.4%	4.4%	1.5%
MSCI EM (USD)	3.1%	8.7%	11.6%
Commodities (CRB index)	**-0.2%**	**2.3%**	**12.9%**
WTI oil (US$/barrel)	2.3%	0.6%	44.4%
Gold (US$/ounce)	3.7%	8.6%	9.0%
Copper (US$/tonne)	-0.5%	8.0%	17.4%
Forex (DXY - US Dollar index)	**1.6%**	**-1.1%**	**3.6%**
USD per EUR	-1.7%	0.7%	-2.9%
CAD per USD	2.1%	-1.0%	-2.9%

Source: Datastream 2/28/2017

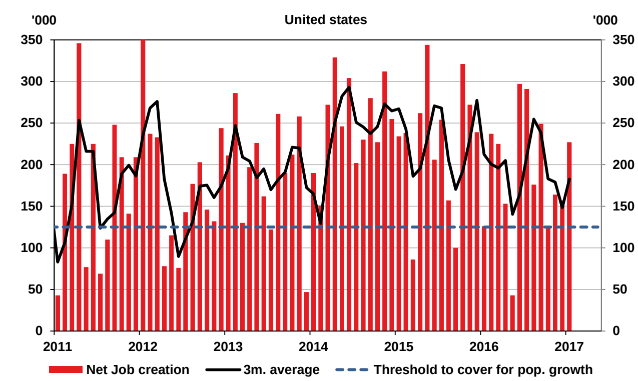
Fixed income: the Fed's Groundhog Day

As we witnessed Janet Yellen's testimony to Congress in which she stressed the need for raising rates at an upcoming meeting, we couldn't shake the feeling we were living an unrelenting Groundhog Day, as it wouldn't be the first time the Fed backtracked after signaling a possible tightening in near future. Whether this time will be different remains to be seen, but the Fed Chair somewhat hedged her comments by pushing for data dependency.

The FOMC does have some reasons to feel more hawkish. Employment showed renewed strength as the U.S. added more than 220 thousand jobs in January - way more than what's needed to cover for demographic growth (chart 1). Since the end of 2016, most economic figures have surprised to the upside to the point where we have now reached levels unseen since 2014 (chart 2).

However, foreign and even domestic risks could throw the Fed's best laid plans off. The list is long: Brexit news is a gift that keeps on giving, Greece is back on the menu, Trump remains a wildcard, while populism in France is gaining traction. Le Pen is leading in the polls for the first-round of elections on April 23, and has a non-negligible chance of winning it all (chart 3).

This part of the Fed's dual mandate is fulfilled



Source: Datastream
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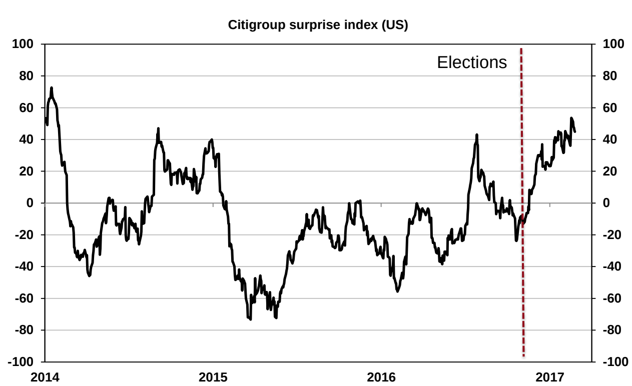
Two surprises since Nov. 8th: Trump and the economy



Source: Datastream
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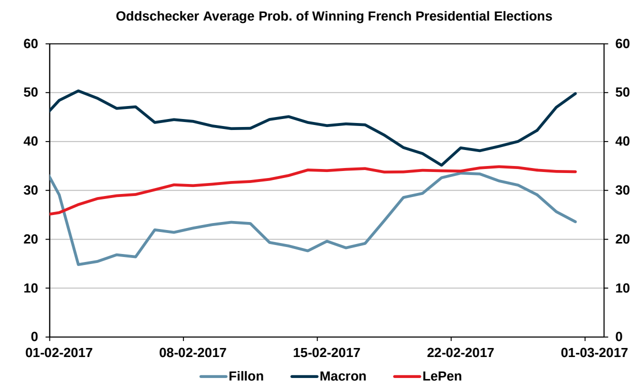
Is the « Le Pen » vote underrepresented?



Source: Datastream
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The Fed is well aware that those risks have the potential to affect monetary policy decisions in the future. However, it seems some members are pushing for a hike earlier than the June consensus:

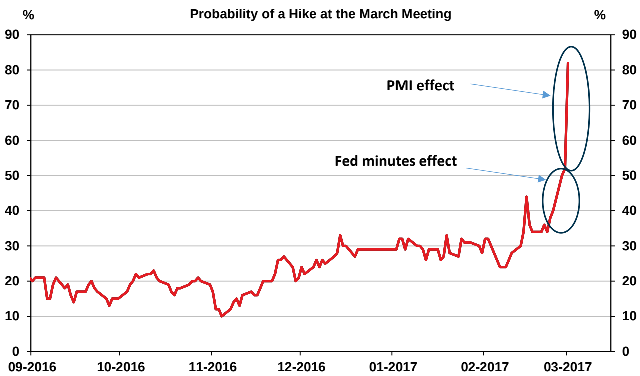
> *"… many participants expressed the view that it might be appropriate to raise the federal funds rate again fairly soon if incoming information on the labor market and inflation was in line with or stronger than their current expectations or if the risks of overshooting the Committee's maximum-employment and inflation objectives increased. A few participants noted that continuing to remove policy accommodation in a timely manner, potentially at an upcoming meeting, would allow the Committee greater flexibility in responding to subsequent changes in economic conditions."*

-Fed Minutes of the January meeting

The likelihood for tightening (now that March is "live") increased from 27% to over 80% since the beginning of February (chart 4, next page). While a hike in March may have a limited impact, an increase in the dots from the summary of economic projections tied to the decision would move the dial much more as it would signal to investors that FOMC members plan to tighten three times 2017.

Our asset allocation positioning for fixed income has not changed much in recent months, as we still believe most yields will have a tendency to appreciate by the end of the year. Therefore, we suggest treading cautiously on the duration-side and investing in shorter-term securities or products offering better protection in a rising yield environment such as non-

A double punch made the hike much more likely



Source: Datastream
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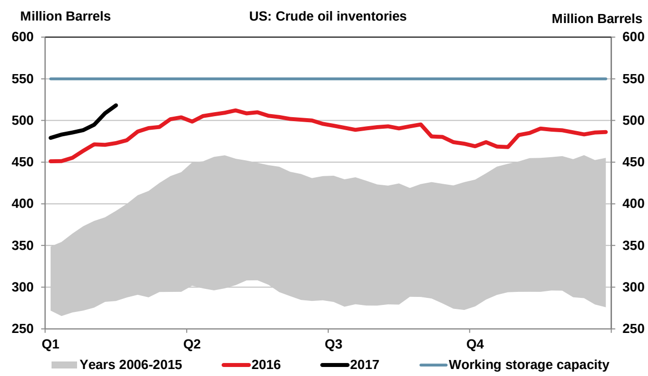
Three months left to injection season



Source: Datastream
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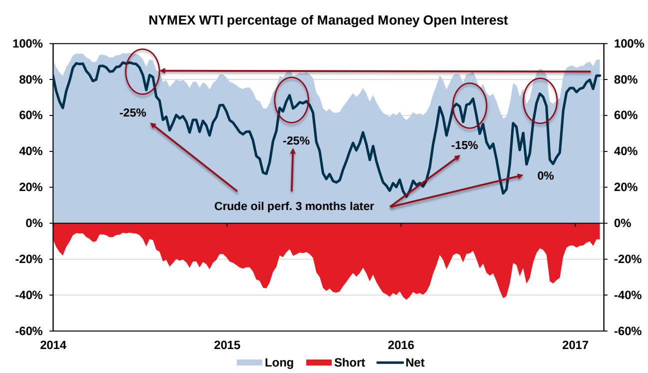
traditional fixed income. If you have to invest in longer durations, we suggest investments with an inflation tilt.
For credit, as we do not expect a recession on the near-term horizon, we think spread products will outperform less risky assets. Corporate earnings should also improve which should reduce, or at least maintain, investment-grade fixed-income spreads in the upcoming quarters. As we are suggesting a short-duration exposure, taking credit risks helps us mitigate earning potential shortfalls from the term premium.

Commodities: Speculative positioning and OPEC

Energy markets are in transition toward a deficit in the first half of 2017, which certainly supports prices at current levels. However some downside risks persist, and the overall supply and demand picture can change quickly. As OPEC announced unprecedented 90% compliance on the cuts (which reduced supply by 1.5 million barrels a day according to IEA), other countries in the cartel not subjected to the agreement materially increased their output. Libya ramped up production to a two-year record, and Nigeria continues to accelerate its activities. As a result, inventories have shot up in the continental U.S. to record levels (chart 5) in part due to imports from a supply push by OPEC producers before January (the date at which the agreement kicked in), and the U.S. is now producing 500 thousand barrels per day more than the trough witnessed in July 2016.

While we expect the fundamental picture to clear up fairly soon, crude oil positioning by market participants are reaching record levels. Speculators are still buying in droves, while producers are more than willing to hedge and sell to them. The situation has now deteriorated even more than last month to a point where speculators have never been this long since July 2014 (chart 6). An orderly winding down of this positioning is possible, but higher volatility, especially on the downside should not be excluded.

If we recall, 2014 wasn't a great year for crude oil



Source: Datastream
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Currencies: Greenback feedback loop

As go U.S. yields, so does the U.S. dollar. The aftermath of the two-week run-up after the election saw products fluctuating in a tight range without any clear direction. The fact that the two are closely correlated at the moment is not surprising – not only because the Fed is the only Central bank considering tightening, but also because FOMC members see the currency's appreciation as a headwind to inflation and economic growth. Others are mostly in an accommodative mood which should increase the greenback's value compared to other currencies as the rate differential increases.

Usually, a hike that has been expected for a long time will have very little impact on financial markets. However, the March meeting dot plot may be more hawkish than the previous one, and we think it should generate upside pressure on the currency.

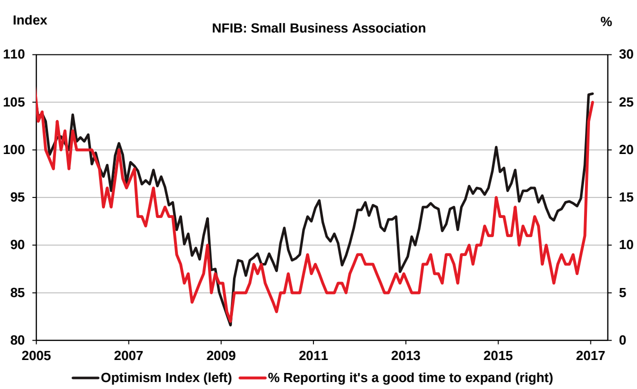
As for the Canadian dollar, risks are on the downside as the currency could weaken if the FOMC tightens in March or if crude oil drops because of a reversal of speculative positions (a subject we discussed earlier). Consequently, we suggest keeping a large portion of investments in USD un-hedged for the time being.

Equities: Optical illusions

Investing in equities has now become a question of optics. The class may look attractive or not depending on the lens used to analyze them. They are certainly exhibiting a curious mix of *the good, the bad,* and *the ugly*:

1. **<u>The good:</u>** The newly minted President's potential policies have greatly increased business confidence (chart 7). Whether this mood eventually translates to new business expenses or hiring remains to be seen, but it is a positive development nonetheless.

Making confidence great again

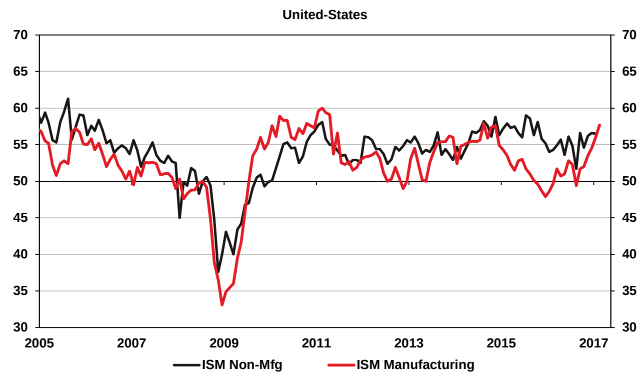


Source: Datastream
7

Since mid-November 2016 financial conditions have constantly eased (which helped the underlying environment for returns), PMI figures are also still going strong and are deeply in expansionary mode (chart 8). Consequently, equities are also the best asset class to benefit from an accelerating growth environment. This is especially true when other investment possibilities such as fixed income, seem to offer lower potential returns. While a FOMC tightening of monetary conditions could have some adverse effects on equities, bonds would stand to suffer more under this type of scenario, and this relative-value play should continue to favour stocks on a medium-term basis.

2. **<u>The bad:</u>** If policies set forth by the U.S. administration have less amplitude than what was previously announced, equities should suffer as we would expect that the reasons for appreciation would be just as valid the other way

Expansion is now well entrenched



Source: Datastream
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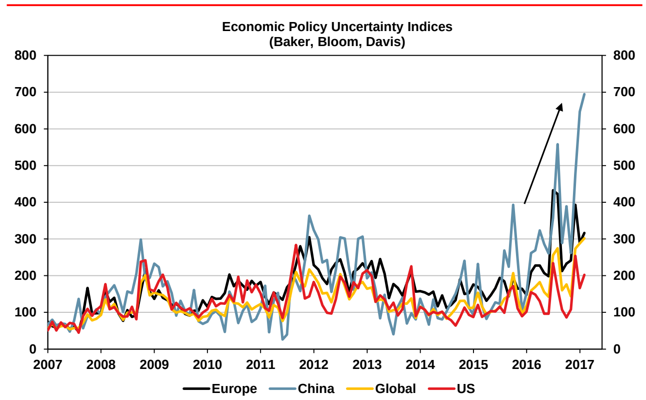
around. The same is true for the underlying economic situation. While most investors were pleasantly surprised by the renewed growth and employment push, it resulted in higher earnings assumptions and set the bar higher as a result, meaning the potential for disappointment has also increased. This is especially true if the U.S. economy starts losing some steam, or the Fed drops the ball by either rising rates too fast or too slow (letting inflation run out of control).

As we discussed earlier, there are also risks in Europe (Brexit, France, Greece) which could put a stop to the upward trend. Oddly enough, despite record business confidence, policy uncertainty has never been this high globally (chart 9). This is a direct consequence of the rise of populism and protectionism across the globe. We believe some of these risks have been discounted too much or just plainly ignored by investors, and we wouldn't be surprised if markets react strongly should one or a couple of them materialize.

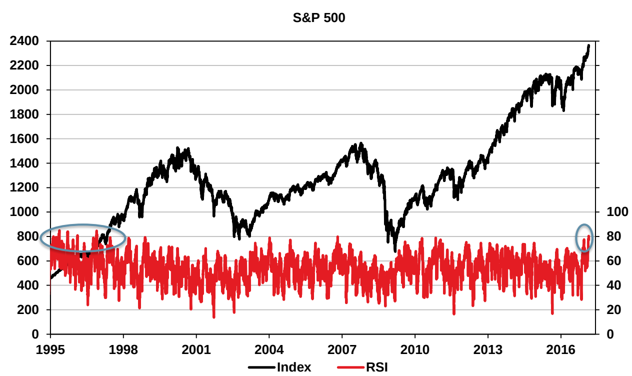
Populism and potential trade wars = uncertainty



Source: Boomberg, policyuncertainty.com
9

3. **<u>The ugly:</u>** The RSI briefly crossed over 80, a first since… 1996 (chart 10)! Price volatility is also eerily low as the realized three-month standard-deviation is now standing at 6.3%, a level close to what we witnessed prior to the financial crisis (chart 11).

A first since… the dot-com bubble!



Source: Datastream

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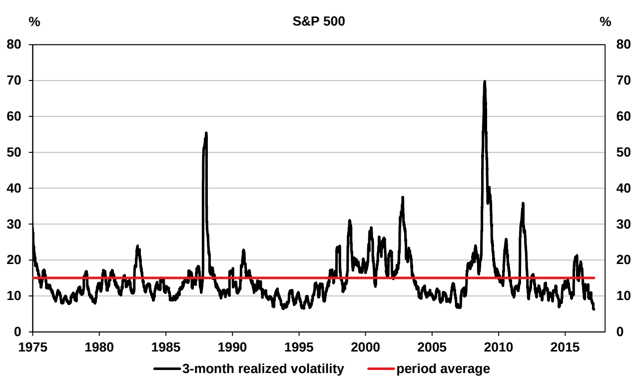
Volatility at 40% of the average



Source: Datastream

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Fundamentally, while a 10%+ earnings growth is expected for 2017, we are left wondering how much of it is already priced in when the 12-month forward PE for the S&P 500 is now registering 17.8.

While technical indicators point to extremes and equity valuation ratios look expensive, it doesn't mean a material downturn is in the cards… yet. However, they paint a picture of complacency as this renewal on the upside seems to depend more on the absence of bad news than a really great fundamental push. This means the bull market has the potential to continue until one of the risks we discussed previously (or a new unexpected one) materializes, the timing of which will be hard to predict.

The first inclination is to think that the recent move is a follow through of the Trump trade. But, this is not really the case as the leadership has transitioned from small- to large-cap companies (chart 12). Consequently, if most of the risks we enumerated are either foreign-based or related to free trade, we think this switch puts the rally in an even more vulnerable state. Large-cap companies will be more exposed to those risks than their smaller counterparts and, as we assess the probabilities and impact of potential news, we think there's an asymmetry in the returns that's skewed to the downside.

Large caps are roaring back

Source: Datastream

12

The potential pitfalls are numerous, but we don't know what risk could finally stick to this Teflon market. And, there's no point into fighting the trend as this run-up in prices can last longer than what anyone expects. As such, we suggest a neutral position for U.S. equities for the time being.

For their Canadian counterparts, the risks are slightly different but the conclusion is the same. NAFTA re-negotiations loom large, and the current speculative positioning in crude oil puts energy companies and the overall S&P/TSX (via its large energy exposure) at risk.