INVESTING

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Asset Allocation Strategy

Seeing the forest for the trees

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Highlights

- Considering the Fed's continued commitment to monetary policy tightening and potential balance sheet reduction announcements by year-end, we believe that yields will have a tendency to appreciate in the coming quarters and, consequently, we suggest a short duration position.
- In credit, the impressive performance we witnessed in 2016 is now behind us and the potential for further contraction of spreads is now much lower, particularly for ones on the more risky side. As such, we think it is now sensible to keep a neutral position for high yield and favour corporates.
- For crude oil, the downside pressure should be more than compensated by other fundamental factors which point toward improvement in the coming months. Inventories have already started to draw, which is one month earlier than the seasonal norm. This means that not only are we close to a balanced market, but that the OPEC cuts are working.
- Even though the loonie weakened materially since the beginning of the month, we would advise caution before deciding to hedge. The fact is that political imperatives can overshadow any of the best laid plans and push prices beyond what would be reasonable or deemed attractive.
- While the earnings seasons have positively surprised, markets still haven't found a way to generate any meaningful momentum and they remain in wait-and-see mode. We are still worried about high valuation levels and what they will mean for returns going forward. However, we cannot ignore the current economic environment which remains healthy, and this economy-vs.-valuations conflict is the reason we remain neutral on equities for the time being. We prefer European equities and would suggest a higher allocation to that region compared to their counterparts.

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

- Loss of 0.13bps on U.S. 10-year yields, as expectations for a hike dampened a bit in light of weak Q1-2017 GDP numbers.
- Canadian counterparts witnessed a similar lower yield path at the beginning of the month, only to rebound and close out April at 1.55%

Canadian equities

- The S&P/TSX held up quite well despite crude oil's performance and President Trump's itching for a trade war.
- The healthcare sector suffered once again from important losses as Valeant's poor showing continued.
- By excluding healthcare, the defensives were the best performers with consumer staples and telecoms recording impressive gains.

U.S. equities

- A good earnings season is helping the S&P 500 test new highs.
- Once again, the index benefitted from an impressive breadth of market as the majority of sectors were in positive territory.
- Since the beginning of the year, only two sectors are negative year-to-date.

Commodities

- Crude prices were strong at the beginning of the month, but fears about China's growth and stock market weakness reversed the course.
- Rising tensions between the U.S. and North Korea, as well as French elections uncertainty, helped gold rally at the beginning of the month. But, the trend changed as the potential for a Le Pen win in the second round dramatically decreased.

Foreign exchange

- The loonie lost big due to a triple punch from weaker energy prices, President Trump's trade war rhetoric, as well as weaker domestic inflation numbers.
- The greenback also weakened compared to other major currencies as the Euro benefitted from decreased political risks tied to the French elections. Prime Minister May's call for elections in the UK, which could translate into a smoother Brexit negotiation should she win, also helped the Euro appreciation.

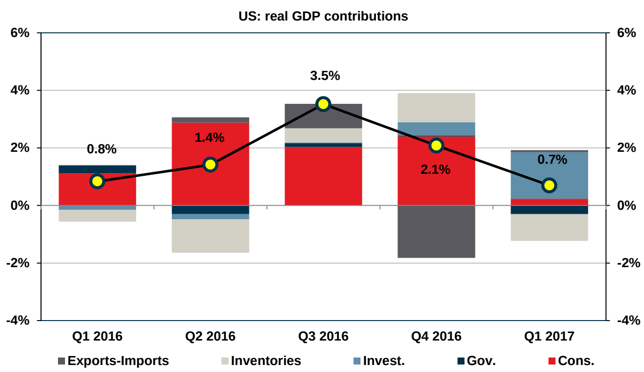
Table 2 Market Returns

Asset classes	April	YTD	2016
Cash (3-month T-bills)	0.1%	0.2%	0.5%
Bonds (FTSE/TMX Ovr. Univ.)	**1.4%**	**2.7%**	**1.7%**
FTSE/TMX Short term	0.4%	1.1%	1.0%
FTSE/TMX Mid term	1.4%	2.9%	1.6%
FTSE/TMX Long term	2.9%	4.8%	2.5%
FTSE/TMX Government	1.4%	2.4%	0.9%
Federal	1.0%	1.6%	0.0%
Provinces	1.8%	3.2%	1.8%
Municipales	1.7%	3.4%	2.0%
FTSE/TMX Corporate	1.5%	3.4%	3.7%
AA+	0.7%	1.7%	2.0%
A	2.1%	4.2%	3.6%
BBB	1.7%	3.9%	5.1%
BoAML High-Yield (USD)	1.1%	3.8%	17.5%
Preferred shares	0.0%	7.5%	7.0%
Canadian Equities (S&P/TSX)	**0.4%**	**2.9%**	**21.1%**
Energy	-0.2%	-5.7%	35.5%
Industrials	2.4%	7.9%	22.8%
Financials	-1.4%	2.0%	24.1%
Materials	-0.3%	5.8%	41.2%
Utilities	0.1%	7.4%	17.7%
Cons. Disc	4.0%	11.3%	10.7%
Cons. Staples	5.3%	8.1%	7.5%
Healthcare	-7.2%	-16.6%	-78.4%
IT	3.6%	10.8%	5.2%
Telecom	5.7%	10.9%	14.7%
REITs	1.8%	6.6%	9.1%
S&P/TSX Small cap	-2.1%	-0.6%	38.5%
US Equities (S&P500 / USD)	**1.0%**	**7.2%**	**12.0%**
Energy	-2.9%	-9.4%	27.4%
Industrials	1.8%	6.4%	18.9%
Financials	-0.8%	1.7%	22.8%
Materials	1.4%	7.3%	16.7%
Utilities	0.8%	7.2%	16.3%
Cons. Disc	2.4%	11.1%	6.0%
Cons. Staples	1.0%	7.5%	5.4%
Healthcare	1.5%	10.0%	-2.7%
IT	2.5%	15.4%	13.8%
Telecom	-3.3%	-7.1%	23.5%
REITs	0.1%	3.6%	3.4%
Russell 2000 (USD)	1.0%	3.2%	19.5%
World eq. (MSCI ACWI)	**1.6%**	**8.8%**	**8.5%**
MSCI EAFE (USD)	2.6%	10.2%	1.5%
MSCI EM (USD)	2.2%	13.9%	11.6%
Commodities (CRB index)	**-1.4%**	**0.3%**	**12.9%**
WTI oil (US$/barrel)	-2.4%	-8.3%	44.8%
Gold (US$/ounce)	1.7%	9.5%	9.0%
Copper (US$/tonne)	-1.8%	3.4%	17.4%
Forex (DXY - US Dollar index)	**-1.3%**	**-3.1%**	**3.6%**
USD per EUR	1.8%	3.2%	-2.9%
CAD per USD	2.5%	1.6%	-2.9%
Source: Datastream			4/28/2017

Fixed income: The case for reducing credit risk

The minutes tied to the Fed Board Meeting of March 2017 gave an overall upbeat reading of the economy and were relatively hawkish. The assessment about the potential for lower Q1-2017 GDP numbers (chart 1) was probably due to "transitory factors," which is another way of saying the measure has fallen victim to seasonal adjustment problems, yet again.

Once again, a weak start to the year



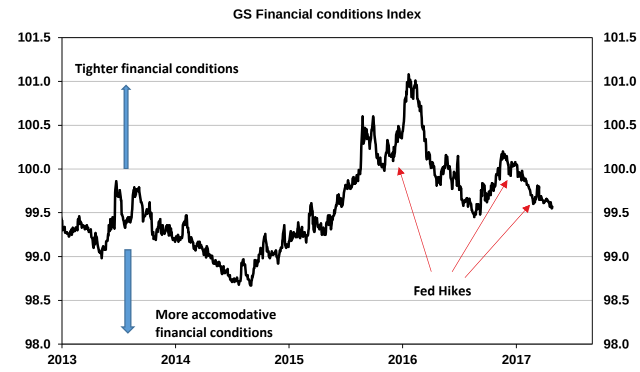
Source: Datastream
1

As expected, the willingness to further tighten policy was discussed. However, the most important piece of information regarded the balance sheet reduction.

> *"Provided that the economy continued to perform about as expected, most participants anticipated that gradual increases in the federal funds rate would continue and judged that a change to the Committee's reinvestment policy would likely be appropriate later this year."*
>
> -Fed Minutes, March 2017 Meeting

This would add yet another point of pressure to the upside on the longer duration part of the yield curve. Markets now anticipate one and a half hikes by the end of the year, due to reduced expectations that the Trump administration will be able to pass reflationary fiscal legislation. We need to remember that this plan and its potential impact were not taken into account by the FOMC to start with and implies that the base case scenario for three hikes in 2017 should remain intact. The bank's commitment to tightening doesn't seem to have changed much, especially when financial conditions remain very accommodative (chart 2) and, consequently, we think there's some surprise potential on the upside for bond yields.

Financial conditions shouldn't stop the Fed from hiking



Source: Datastream
2

Technically, there's still no clear trend (chart 3). After an unconvincing breach below the 2.30% level, we are back into the range with the 100-day moving average (MA) acting as resistance (2.39%). The 2.60% level will also act as a major point, as any rise over that level would be considered very bearish for fixed-income products.

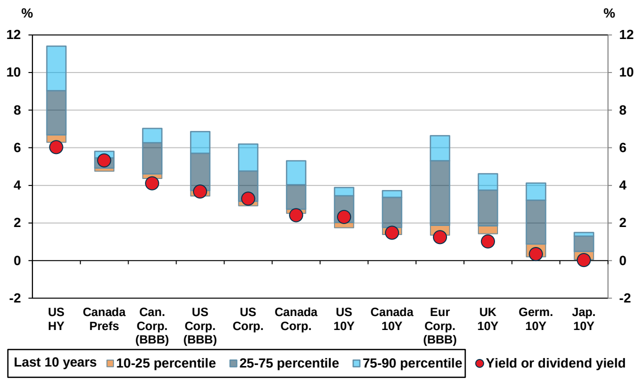
Back in the range after a false break

Source: Datastream
3

Considering the Fed's continued commitment to monetary policy tightening and potential balance sheet reduction announcements by year-end, we believe that yields will have a tendency to appreciate in the coming quarters and, consequently, we suggest a short duration position or assets that offer protection in a rising yield environment.

For credit, the impressive performance we witnessed in 2016 is now behind us and the potential for further contraction of spreads is now much lower, particularly for ones on the more risky side. If both High Yield and Investment Grade credit narrow to historical lows, potential capital gains in the former would barely be higher than those of the latter, and at a higher risk, since a return to the median would entail a much bigger loss for High Yield bonds (charts 4 and 5).

Percentiles, High yield: 3%, US corps.: 32%



Source: Datastream

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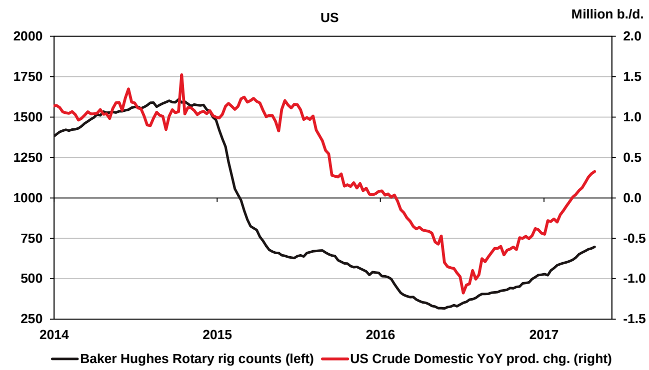
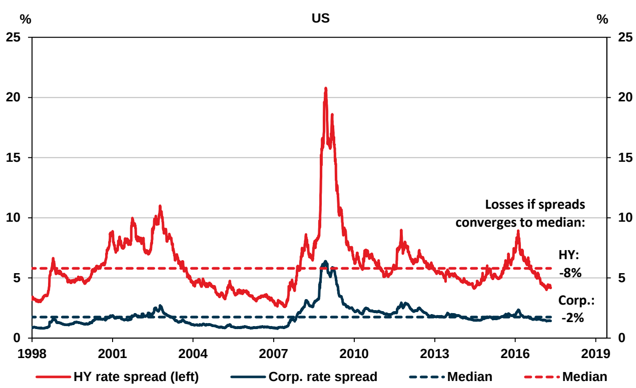
Crude oil: US activity is picking up



Source: Datastream

6

Less and less space for improvement for High-Yield bonds



Source: Datastream

5

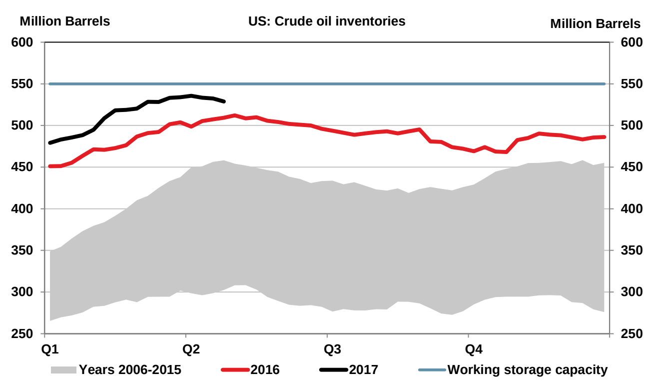
However, as we do not expect a recession in the next quarters, we think credit is still a risk worth taking, especially in light of the term premium shortfall generated by our short duration position. As such, we think it is now sensible to keep a neutral position for high yield and favour corporates.

Commodities: Fundamentals vs. risks

As crude oil prices were closing in on the December-February range, prices dropped in tandem with Chinese stock markets as regulators in the country are tightening controls on leverage and speculation. While we argued before that equities should not serve as a proxy for the overall state of the economy, commodity markets are always nervous when any sign of instability or trouble emerges from China. This month is no exception. In North America, the U.S. production growth is also cause for concern for energy prices, as shale oil activity continues to pick up and is now pushing the U.S. in production growth territory on a year-over-year basis (chart 6).

However, this downside pressure should be more than compensated by other fundamental factors which point toward improvement in the coming months. Inventories have already started to draw, which is one month earlier than the seasonal norm (chart 7). This means that not only are we close to a balanced market, but that the OPEC cuts are working. The Cartel's talk about extending the agreement should also make headlines in the coming weeks and help stymie any potential downward pressure going forward.

Draws one month earlier than seasonal norms

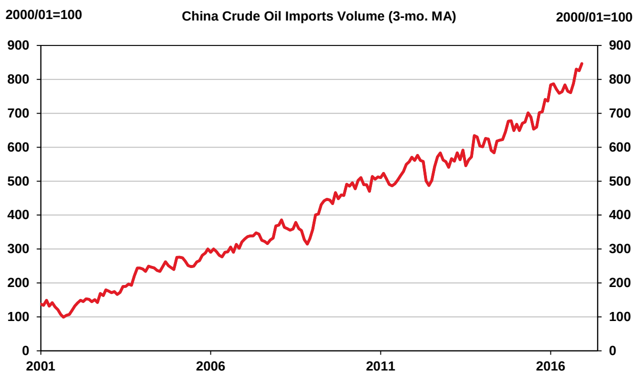


Source: Datastream

7

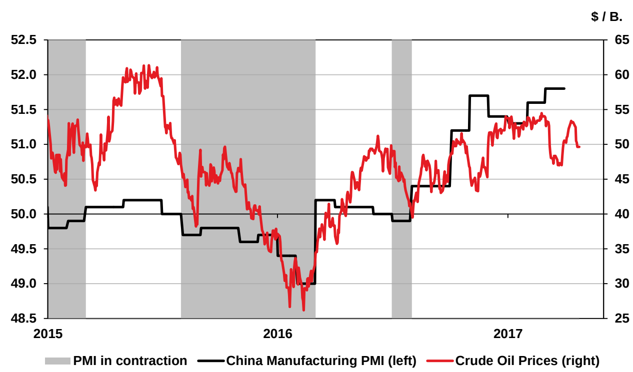
As for China, while recent stock market performances have put some old slowdown risks back on the radar, crude imports continue unabated (chart 8). For 2017, it is expected that a quarter of the world's demand growth for the product will come from China. So, any hiccups on the economic side would certainly impact the supply-and-demand picture and prices in a material way. For now, we think this is only a bump on the road, but we will keep a close eye on further developments. However, as long as their domestic economy remains in expansion, a material downturn is less likely (chart 9).

Don't bet against Chinese demand for crude oil



Source: Datastream
8

Chinese PMIs are well correlated to crude oil



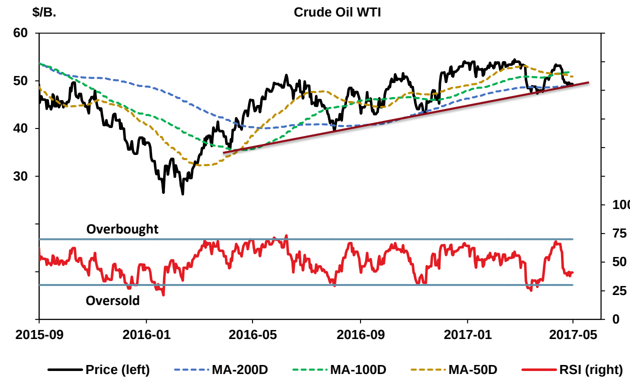
Source: Datastream
9

Technically, the mid-month drop broke through the 50D-MA and 100D-MA, but the 200D-MA should act as a floor (chart 10). The trend line set in April 2014 will also prove a formidable support, as it has now been confirmed three times and gained validity with each rebound. A break on that front would mean the floor would decrease to 40-42$. On the upside, the story remains the same – we expect some resistance from the recent highs of $54.50.

Currencies: Proxies for political risk and trade wars

Currencies now seem to be the vessels of choice to express views on market risk for speculators, as realized volatilities remain fairly low for equities (compared to the past) while foreign exchange pairs have witnessed moves tied to political announcements, geopolitical events, election results and, sadly, tweets.

Crude oil: A strong trenline should act as support



Source: Datastream
10

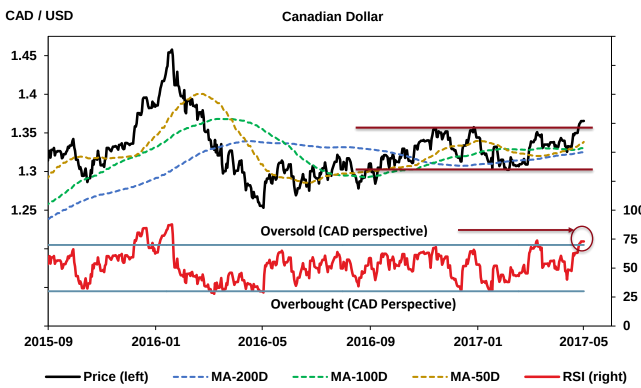
April has been a pretty eventful month. The Euro witnessed a relief rally tied to the increased probabilities of Marine Le Pen (or Mélenchon, for that matter) not taking power, while the pound jumped 2.0% after British PM Theresa May called for a snap election that she is expected to win handily. Such an outcome is deemed positive for Brexit negotiations, as the PM's current slim majority limits her flexibility. Should she win a strong mandate, the hard Brexit MPs would have less influence and she would have much more leeway in implementing a deal that would favour an orderly withdrawal.

For the loonie, the story is different as the currency is now facing some headwinds. The levy by the U.S. administration of a 20% (average) duty on softwood lumber marks the fifth dispute on the subject since 1982, and is the factor with the potential of greatest impact in the foreseeable future. In addition, Mr. Trump criticized Canada for support of its milk producers and he also pondered scrapping the NAFTA deal, before eventually reversing course. While one could argue that the economic impact of the softwood lumber sector is somewhat negligible for Canada (for example, it represents 0.3% of total Canadian jobs), this is yet another episode since November 8, 2016, in which the U.S. government is blowing hot and cold regarding trade. NAFTA re-negotiations are due to begin later this summer, and the fact that these issues come up right before the starting line is no coincidence. They should be considered as the opening bids by the -President to soften up the Canadian and Mexican positions.

The energy price drop also adds to the selling pressure for the loonie. However, as we discussed in the commodities section, we think this may be temporary. The problem resides with the timing of the downturn as we are currently breaking through some technical levels for the Canadian dollar and further weakness in crude oil could add fuel to the fire.

For the loonie, the top of the range at 1.36 CAD/USD has been broken and there's very little in line that could stop the slide going forward, except for the oversold RSI (chart 11).

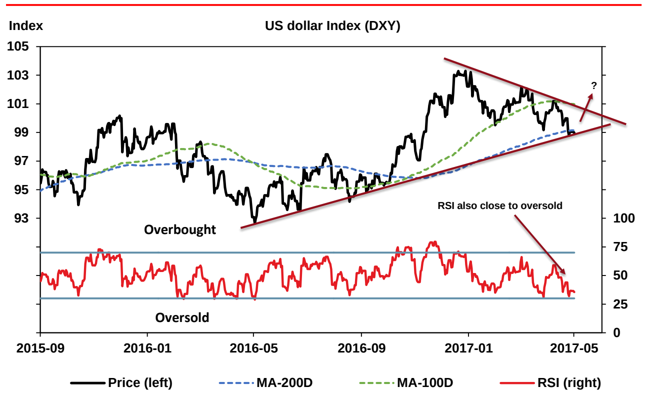
Will politics overpower the oversold technicals in CAD?



Source: Datastream
11

Its southern counterpart is now witnessing a symmetrical triangle. It has been forming for a while and is usually considered a continuation pattern, which means that if the analysis proves to be true, we should see prices resume on the upside shortly (chart 12). The lower trend line has gained more and more validation as levels kept rebounding on it and should act as a support.

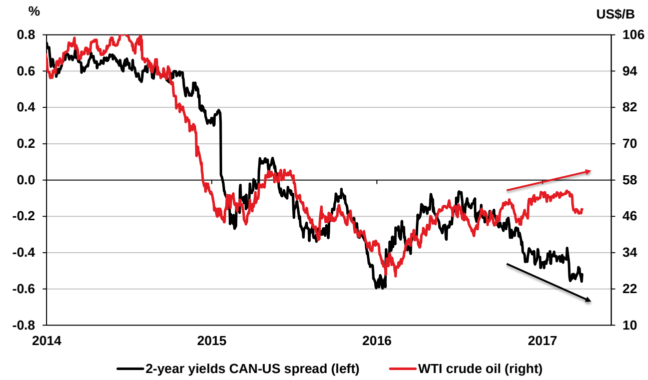
US dollar: will the triangle act as continuation pattern?



Source: Datastream
12

Even though the loonie weakened materially since the beginning of the month, we would advise caution before deciding to hedge. The fact is that political imperatives can overshadow any of the best laid plans and push prices beyond what would be reasonable or deemed attractive. We also need to take into account the divergence between the loonie's fundamentals – oil prices and interest rate spreads – which are sending conflicting signals (chart 13).

A divergence of forces on the loonie since Q3-2016



Source: Datastream
13

As discussed previously, we expect crude oil to rebound, but NAFTA negotiations will remain a wildcard and we think the currency will experience further volatility. Consequently, we think a neutral position is the best course of action until the dust settles and we get a clearer picture.

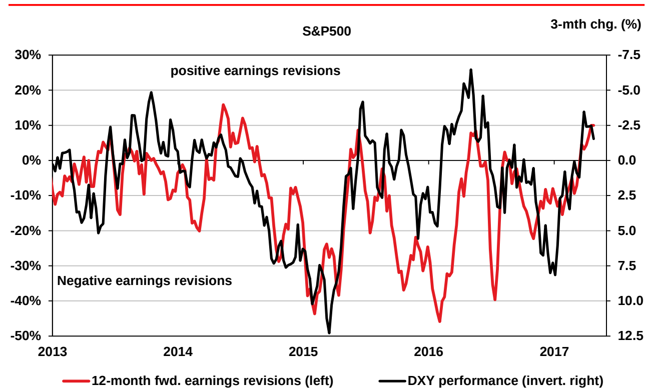
Equities: Go east young man

Earnings for Q1-2017 have been generally good, and we witnessed many more surprises on the upside than the reverse. This backdrop, tied to surveys continuing to show general enthusiasm for the economic outlook, pushed equity markets higher. While one cannot ignore the current healthy state of the economy to explain earnings growth, recent U.S. dollar weakness should also be considered a factor (chart 14).

However, we feel inclined more and more to suggest investing in Europe instead of in the U.S., and the reasons are numerous:

1- **<u>Valuations:</u>** most of the metrics we look at show Europe is less overvalued than its counterparts (table 3) – not only

Greenback performances have a big impact on earnings



Source: Datastream
14

Table 3: **Valuation Comparison**

	S&P 500		MSCI Europe	
Ratio	**Value**	**Percentile**	**Value**	**Percentile**
P/E ratio	19.3	79%	16.6	70%
12m. FWD P/E	17.4	81%	14.8	66%
PEG Ratio	1.57	73%	1.46	30%
P/B Ratio	2.95	88%	1.77	55%

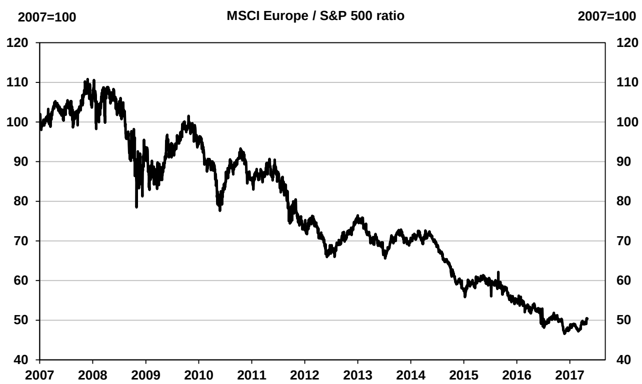
Source: Datastream and I/B/E/S

All Percentiles use historical data since Jan.2000 except for P/B (Jan.2004)

by comparing them to each other, but also by checking each market's current numbers compared to its own historical values or earning revisions.

While favourable valuations are not necessarily sure bets toward better returns, we think they have better potential rewards for the risk taken. The fact that the ratio between the two indices has reached an extreme level furthers our case (chart 15).

The end of the great European underperformance?



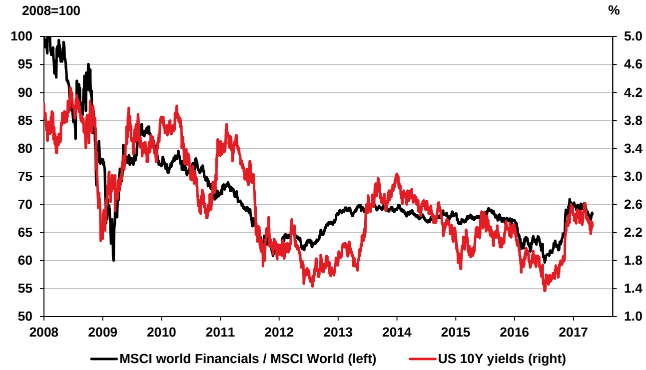
Source: Datastream

15

2- **Index composition**: As we discussed last month, earnings growth is more diversified in Europe and is less exposed to energy prices which are volatile. The higher financial sector weightings in Europe should also be considered advantages going forward, as reduced regulatory hurdles will help not only U.S. financial institutions but also major European ones. Higher rates down the road and steeper yield curves would also have positive impact on bank earnings (chart 16).

3- Politics: Expectations for fiscal policy are still running high in the U.S. (as portrayed by confidence numbers still hovering around post-election levels) and we think the potential for disappointment on that front is underrated. The healthcare reform failure may well be the first warning shot of additional resistance as Mr. Trump is now trying to implement his tax reform plan which looks more and more like a simple tax cut than outright reform of the code.

Higher rates will help financials worldwide



Source: Datastream

16

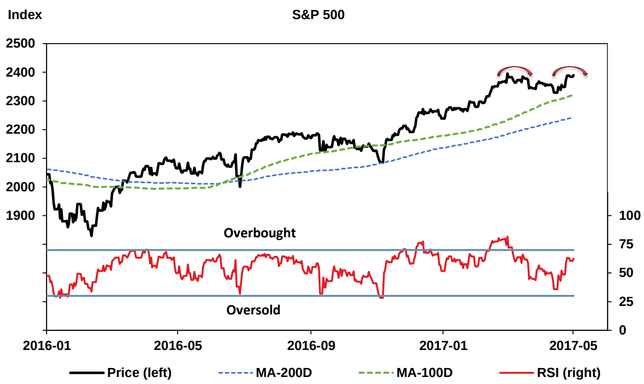
His announcement on April 26 called for the corporate rate to be lowered to 15% (from 35%) and some changes to individual rates. There is very little in line for additional revenues, except for the closing of some loopholes and some lower repatriation tax levels on offshore profits which would help pay for infrastructure programs. The chances of these cuts making it into law remain unknown, and fears about ballooning deficits are certain to concern Democrats and the fiscal hawks' branch of the GOP. This plan is the base case scenario. Any reduction in scope, or plain failure on the part of the President to pass this through, should be met with disappointment by investors which expected more following the election results.

While we agree that Brexit negotiations should be a form of drag in Europe, the conclusion is too far away to have an immediate impact and we think the bulk of the effects are priced-in.

The S&P 500 is still flirting with the 2400 level that was briefly reached on March 1. Any failure to break it would form a double top and put the rally at risk with a support at 2328 (Chart 17).

While the earnings seasons have positively surprised, markets still haven't found a way to generate any meaningful momentum and they remain in wait-and-see mode. We are still worried about high valuation levels and what they will mean for returns going forward. However, we cannot ignore the current economic environment which remains healthy, and this economy-vs.-valuations conflict is the reason we remain neutral on equities for the time being. As discussed previously, we prefer European equities and would suggest a higher allocation to that region compared to their counterparts.

Beware of a potential double top



Source: Datastream
17