NATIONAL BANK INVESTMENTS

ASSET ALLOCATION STRATEGY

November 1st, 2017

Green is also a fall color – stay the course

Highlights

- Our asset allocation has not changed for November, the global economic backdrop is still healthy and conducive to a risk-on mindset, which favors equities over fixed income.
- After a pick-up of 40 bps over the last two months that took yields on U.S. 10-year notes above their long-term trend, markets look bound for a short-term reversal. With current expectations of a gradual phase-in for corporate tax cuts from a rate of 35% in 2018 to 20% in 2022 (an equivalent of three percentage points per year), it will be difficult for yields to maintain their upward momentum.
- Foreign exchange moves were Central Bank motivated in October, as monetary policy adjustments decided the direction and volatility of currency pairs. For the euro, the ECB announced that, starting in January, it was halving its stimulative bond purchases to 30 billion euros a month. However, the big story was the commitment to keep buying bonds beyond September 2018, if the Governing Council believes it necessary.
- For the Canadian dollar, we expect the $1.30 to be the next resistance. This level will be key in assessing the plan regarding currency hedges. If the loonie punches through without an afterthought, we will wait for the weakness to subside before hedging. However, if the trend starts to reverse around $1.30 we think it would be wise to start selling U.S. dollars in favour of the Canadian dollar.
- It is undeniable that crude oil risks were skewed to the downside in the past. However, the fortunes have recently turned as the uptick in global demand spurred by synchronized global economic growth have evened things out. The fundamental picture has strengthened and deficits are now well entrenched, and the inventories are starting to normalize in the U.S. and the world.
- Separating equity returns between forward earnings growth and PE expansion paints a picture in favour of the Canadian index over the US one, as 100% of the S&P/TSX 2017 performance was propelled by earnings growth. In other words, we believe that the valuation gap continues to depict a better risk-reward profile north of the border.

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: CIO Office

Current Allocation ■
Previous Month Allocation

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Market review

Fixed income

- U.S. treasury rates climbed higher in October as the prospect of U.S. tax reform fuelled expectations that such a policy would stimulate growth and inflation, while also increasing the supply of treasury debt.
- 10-year Canadian government rates took a different path, down 15 bps as Governor Poloz' cautious stance and negative GDP figures dampened perceived chances of another Bank of Canada rate increase this year.

Canadian equities

- The S&P/TSX closed above the 16,000 mark for the first time in history, in addition to beating its U.S. counterpart for the third month in a row with a 2.7% return.
- Of the 11 main sectors in the index, 9 advanced in October, as only Health Care and Energy stocks closed a fraction lower.

U.S. equities

- The S&P 500 posted its best monthly gain since February 2017, bolstered by renewed impetus on U.S. tax reform and upbeat corporate earnings.
- Technology companies led the surge, following stronger than expected earnings from blockbuster names such as Amazon, Microsoft and Google-parent Alphabet.

Commodities

- Oil prices remained on their upward trend in October as improving demand, and expectations of an extension to Opec-led production cuts beyond March buoyed prices.
- Similarly, copper prices extended their rally with China's economic tightening and growth slowdown fears receding. The metal is up 26% YTD.

Foreign exchange

- The loonie retreated back below the 80-cent U.S. mark in October as recent economic data confirmed expectations that the economy would likely take a breather up until year-end, after a stunning first half.
- Progress on U.S. tax reform, U.S. economic momentum, and the ECB's tapering decision have helped propel the U.S. dollar index to climb slightly higher, up 1.6% from last month's close.

Table 2 Market Returns

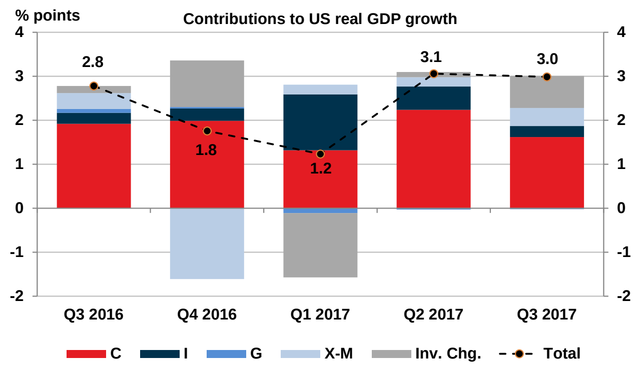
Asset classes	October	YTD	2016
Cash (3-month T-bills)	0.1%	0.4%	0.5%
Bonds (FTSE/TMX Ovr. Univ.)	**1.6%**	**2.1%**	**1.7%**
FTSE/TMX Short term	0.6%	0.4%	1.0%
FTSE/TMX Mid term	1.4%	1.2%	1.6%
FTSE/TMX Long term	3.3%	5.1%	2.5%
FTSE/TMX Government	1.7%	1.8%	0.9%
Federal	1.1%	0.3%	0.0%
Provinces	2.3%	3.3%	1.8%
Municipales	2.1%	3.8%	2.0%
FTSE/TMX Corporate	1.5%	3.1%	3.7%
AA+	0.8%	1.1%	2.0%
A	1.8%	4.0%	3.6%
BBB	1.6%	3.5%	5.1%
BoAML High-Yield (USD)	0.4%	7.5%	17.5%
Preferred shares	2.0%	12.8%	7.0%
Canadian Equities (S&P/TSX)	**2.7%**	**7.3%**	**21.1%**
Energy	-0.3%	-7.9%	35.5%
Industrials	3.4%	18.6%	22.8%
Financials	4.6%	12.1%	24.1%
Materials	1.6%	4.2%	41.2%
Utilities	3.3%	11.5%	17.7%
Cons. Disc	3.3%	21.3%	10.7%
Cons. Staples	2.3%	3.8%	7.5%
Healthcare	-0.2%	-8.7%	-78.4%
IT	2.8%	16.1%	5.2%
Telecom	3.0%	13.3%	14.7%
REITs	0.8%	8.2%	3.4%
S&P/TSX Small cap	1.7%	-0.2%	38.5%
US Equities (S&P500 / USD)	**2.3%**	**16.9%**	**12.0%**
Energy	-0.7%	-7.3%	27.4%
Industrials	0.2%	14.4%	18.9%
Financials	2.9%	15.8%	22.8%
Materials	3.9%	20.3%	16.7%
Utilities	3.9%	16.2%	16.3%
Cons. Disc	2.1%	14.3%	6.0%
Cons. Staples	-1.4%	5.1%	5.4%
Healthcare	-0.8%	19.4%	-2.7%
IT	7.8%	37.2%	13.8%
Telecom	-7.6%	-12.0%	23.5%
REITs	0.8%	8.2%	3.4%
Russell 2000 (USD)	0.8%	10.7%	19.5%
World eq. (MSCI ACWI)	**2.1%**	**20.2%**	**8.5%**
MSCI EAFE (USD)	1.5%	22.3%	1.5%
MSCI EM (USD)	3.5%	32.6%	11.6%
Commodities (CRB index)	**0.0%**	**1.1%**	**12.9%**
WTI oil (US$/barrel)	5.2%	1.1%	44.8%
Gold (US$/ounce)	-1.1%	9.7%	9.0%
Copper (US$/tonne)	6.0%	23.4%	17.4%
Forex (DXY - US Dollar index)	**1.6%**	**-7.5%**	**3.6%**
USD per EUR	-1.5%	10.4%	-2.9%
CAD per USD	3.3%	-4.1%	-2.9%

Source: Datastream 2017-10-31

Fixed Income: BoC pauses, Fed stays the course

In fixed income, economic activity is still supportive of higher U.S. rates. In the third quarter, real GDP growth came out at a stronger-than-expected annualized rate of 3.0%, as consumers continued to spend heftily despite major disruptions caused by successive hurricanes on the southern coastline (Chart 1). Forecasts for growth to the end of the year remain buoyant as reconstruction efforts should be in high gear and the manufacturing PMI, a leading indicator, remains solidly in expansion territory.

1 Sustained US growth in the third quarter



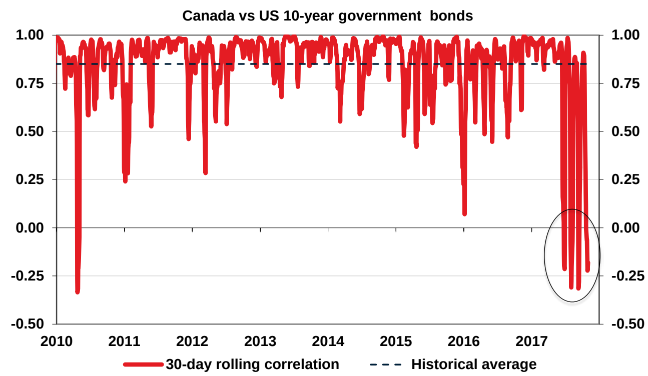
Source: CIO Office, Datastream

However, after a pick-up of 40 bps over the last two months that took yields on U.S. 10-year notes above their long-term trend, markets look bound for a short-term reversal. With current expectations of a gradual phase-in for corporate tax cuts from a rate of 35% in 2018 to 20% in 2022 (an equivalent of three percentage points per year), it will be difficult for yields to maintain their upward momentum. Obviously, one big game-changer would be an acceleration in inflation which would certainly prompt the Fed – and the markets! – to factor in more key rate hikes. For the moment, however, inflationary pressure remains nowhere to be seen, with personal consumption expenditure (PCE) core inflation stable at only 1.3% annually in September – much lower than the Fed's 2% target.

Usually, getting the direction of the U.S. bond market right is enough for Canadian investors, as U.S. yields explain roughly 95% of the fluctuations of similar maturities this side of the border. But, not lately! With the Bank of Canada (BoC) having continuously miscommunicated their intentions over the past six months, the short-term correlation between Canadian benchmark bonds and their U.S. counterparts has rarely been this negative for so long (Chart 2).

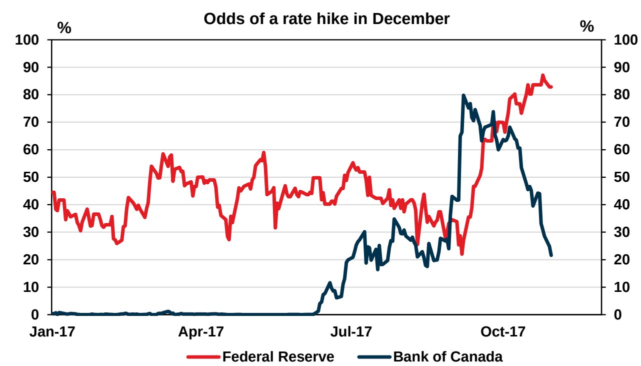
After surprising the markets with two consecutive hikes in July and September 2017, effectively reversing the 50 bps "policy insurance" they took following the collapse in oil prices in 2015, the bank decided to opt for a pause in October. The move was largely expected by investors, but the dovish tone of the Bank's Governor was more than they had hoped for and future rate hikes were pushed to 2018 (chart 3, see Currency section for more details). The end result was a rally in Canadian bonds, with yields falling 18 bps, reversing nearly half of the spread compression we saw from July to early September (Chart 4).

2 Negative correlation: A rare occurence



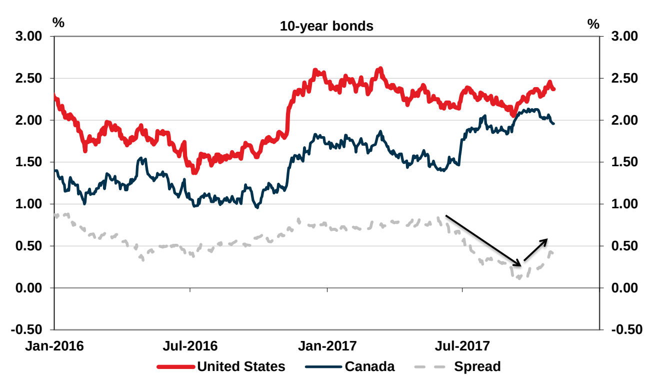
Source: CIO Office, Datastream

3 North American central banks going separate ways!



Source: CIO Office, Datastream

4 Spread compression is over!



Source: CIO Office, Datastream

Currencies: Central Bankers on the forefront

Foreign exchange moves were Central Bank motivated in October, as monetary policy adjustments decided the direction and volatility of currency pairs. For the euro, the ECB announced that, starting in January, it was halving its stimulative bond purchases to 30 billion euros a month. However, the big story was the commitment to keep buying bonds beyond September 2018, if the Governing Council believes it necessary:

> *"… a few members would rather have a closed end date or an announcement or some signal that we would go towards that. But then [sic] the large majority of the Council preferred to have it open-ended.*
>
> *But there was another thing we didn't discuss: tapering. I don't think this word had been pronounced, if I am not mistaken. In any event it was not discussed and so this is not tapering; it's just a downsize. As I said before, it's consistent with our feedback rule which had been – we've been using all throughout."*
>
> -Mario Draghi, Press Conference, 26 Oct. 2017

This statement is a reminder that the ECB will remain accommodative for the foreseeable future. As expected, the greenback shot up on the news and posted a second positive month in a row. Mr. Draghi is not the only factor influencing the pair as Catalonia's plea for independence and Brexit uncertainty are sure to continue weighing on the euro on the short to medium-term horizon.

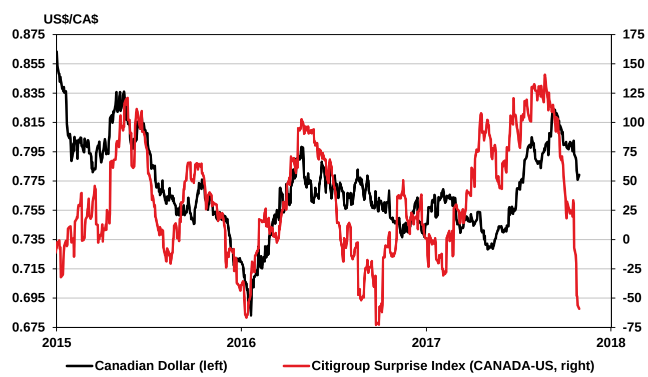
Technically, for the DXY, some key levels have been broken and the 100-day moving average (MA) is the most important one. The next resistance levels are generated by trend-lines and the 200-day MA (Chart 5), which should be tested soon. Unless the Fed causes a dovish surprise or the U.S. economy weakens materially.

5 Will the 96 to 97 resistance levels hold?

Source: CIO Office, Datastream

For the loonie, expectations were running high after the first hike in July 2017, but it seems the one in September became the classic tale of "buy the rumor; sell the fact," as the downturn perfectly coincided with the decision date. What happened? For one, as we indicated in the last months, the Canadian dollar was overdue for a breather, as most technical indicators were signaling an overbought situation. Disappointing economic numbers also started trickling in, such as much weaker than expected retail sales and inflation numbers. These negative surprises, added to a better situation south of the border (Chart 6), generated the perfect environment for a selloff. And, the BoC's dovish statement following the October 2017 meeting, lowering the likelihood of a hike before 2018, was the trigger.

6 Momentum change on both sides of the border



Source: CIO Office, Datastream

Mr. Poloz seems to have erred on the side of caution, and the reasons given for maintaining the status quo are eerily similar to the ones given south of the border: low wage inflation, slack in the labour market, CPI lower than the Central Bank's target, as well as political risks such as NAFTA negotiations. Trying to predict the BoC's view regarding the level of the currency pair has proven to be difficult recently as Mr. Poloz is blowing hot and cold on its impact:

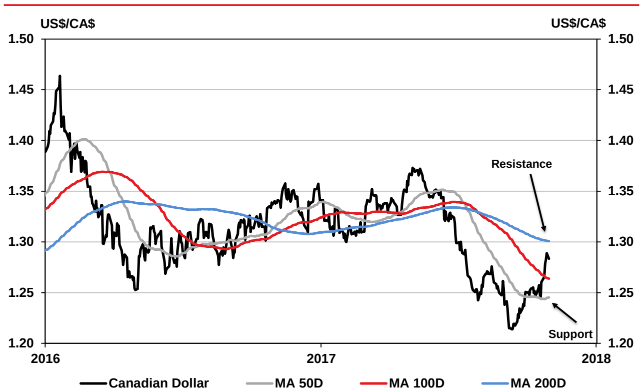
> *"However, significant geopolitical risks and uncertainties around international trade and fiscal policies remain, leading to a weaker US dollar against many major currencies. In this context, the Canadian dollar has appreciated, also reflecting the relative strength of Canada's economy."*
>
> -Meeting Press release (hike), 6 September 2017

"However, projected export growth is slightly slower than before, in part because of a stronger Canadian dollar than assumed in July."

-Meeting Press release (no hike), 27 October 2017

As much as the Canadian Central Bank can influence the direction of the pair, moving averages also seem to be playing a role in setting levels at which the currency turns. The 50-day MA acted as a support for most of October and, now that the 100-day MA has been broken, we could expect the $1.30 to be the next resistance. This level will be key in assessing the plan regarding currency hedges. If the loonie punches through without an afterthought, we will wait for the weakness to subside before hedging. However, if the trend starts to reverse around $1.30 we think it would be wise to start selling U.S. dollars in favour of the Canadian dollar (Chart 7).

7 $1.30 will be key in assessing the loonie's fortunes



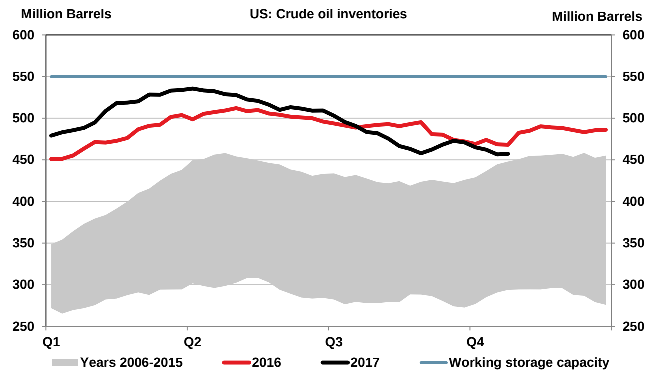
Source: CIO Office, Datastream

Commodities: Finally some breathing room

For crude oil, the coming quarters will be key in assessing the medium-term picture, as we are soon entering a period of seasonal slowdown in demand during which inventory numbers have a tendency to rise. Consequently, we will need to keep a close eye on U.S. and world inventories on a year-over-year basis to see if builds are lower than seasonal averages (Chart 8).

OPEC will also be under the spotlight as most members expect the cartel to extend the deal beyond the March 2018 date; however, there is no expectation that additional cuts will be necessary. It will be interesting to see if the cartel starts giving some clarity toward an exit plan, managing the end of the cuts. Any gradual decrease would be constructive for energy prices, as it would mitigate the risks of a supply shock of 1.8 million barrels per day once the deal expires. The fact the cartel is considering different alternatives in that regard is a positive development in itself, as it shows that members have confidence that the worst of the supply glut is behind us.

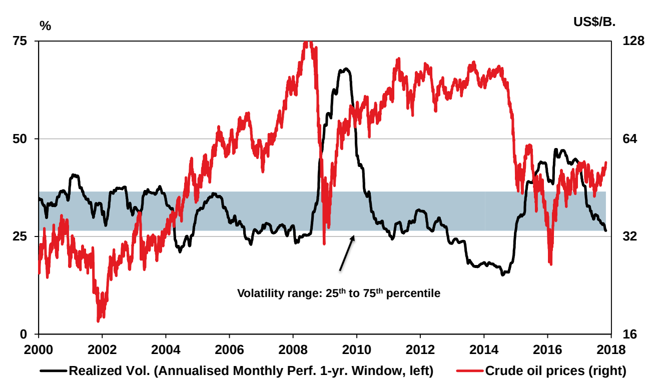
8 We are now entering seasonal inventory builds period



Source: CIO Office, Datastream

We must remember that the run-up since mid-2017 has been fragile in nature, with an uncertain supply-management agreement by OPEC, the constant fear about U.S. shale-oil output, some unconstrained cartel members punching above their weight production-wise, and a massive inventory overhang. It is undeniable that risks were skewed to the downside. However, the fortunes have recently turned as the uptick in global demand spurred by synchronized global economic growth have evened things out. The fundamental picture has strengthened and deficits are now well entrenched, and the inventories are starting to normalize in the U.S. and the world. Confidence in the equilibrium has tamped down extreme price swings, and the effect is visible with a downward trend in realized volatility, which is now nearing the lower part of its historical range (Chart 9). If global synchronized growth continues on its trend and OPEC can manage its exit, we expect energy prices to remain on a slight uptrend in the next quarters.

9 Calmer waters ahead?

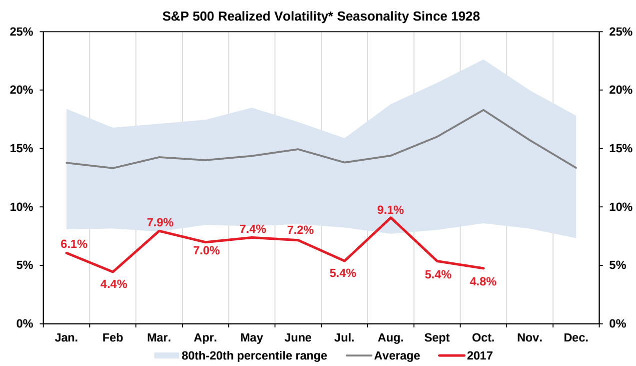


Source: CIO Office, Datastream

Equities: Ain't no mountain high enough

Equity markets have been extraordinarily calm this year, with investors becoming accustomed to political uncertainty. Despite seasonality pointing to a potential pick-up in volatility for October, increasing odds that Republicans succeed in passing tax reform before the 2018 mid-term elections coupled with a supportive Q3 earnings season start have helped prolong record low levels of stress in financial markets (Chart 10). Whether the GOP succeeds in its effort to overhaul the U.S. tax code for the first time in a generation remains far from certain, but it cannot be denied that corporate fundamentals are improving.

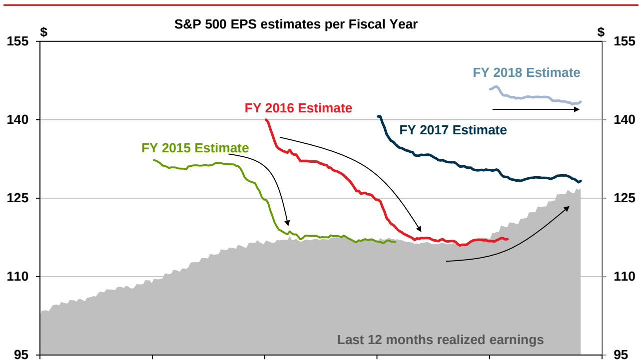
10 2017 Equity markets as calm as a millpond…



Source: CIO Office, Datastream
*Volatility measured by the annualized standard-deviation of daily returns observed during the month

After a two-year pause in earnings growth and estimates systematically being revised lower, realized EPS is finally living up to expectations, aiming at a 9.4% increase for 2017 (Chart 11). Previews for next year are also remarkably stable at $143, a figure that surely reflects some optimism with regard to potential fiscal stimulus but, above all, consistent with the ongoing global synchronized upswing in economic activity. With 62% of S&P 500 companies having reported Q3 results thus far, a solid 73% have posted EPS that topped expectations (Chart 12). Following the trend of recent quarters, technology stocks

11 Earnings finally living up to expectations



Source: CIO Office, Datastrea

12 Third quarter earnings season results

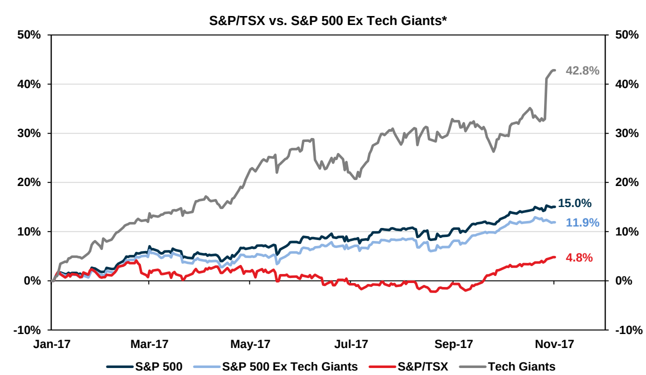
	Reported (%)	Q3/17 YoY Earnings Growth (Blend Estimate)*	Beat (%)	Met (%)	Missed (%)
S&P 500	62%	6.9%	73%	9%	19%
Energy	59%	168.1%	63%	16%	21%
Materials	60%	6.2%	80%	13%	7%
Industrials	75%	2.4%	69%	12%	20%
Consumer Discretionary	44%	3.0%	70%	3%	27%
Consumer Staples	53%	3.8%	72%	6%	22%
Health Care	65%	7.3%	78%	8%	15%
Financials	82%	-7.2%	80%	4%	16%
Information Technology	57%	18.8%	90%	8%	3%
Telecommunication Services	67%	-2.5%	0%	50%	50%
Utilities	46%	-4.5%	62%	0%	38%
Real Estate	70%	2.5%	48%	22%	30%

Source: CIO Office, Thomson Reuters
*Blends actual results for stocks that have Reported for the season in question with expectations for those that are Yet To Report.

led the charge, posting double digit year-over-year growth coming in above EPS projections in 90% of the cases.

As noted in October's AAS issue, the lack of Canadian tech giants has been, and will continue to be, a challenge for the country's index as long as appetite for growth stocks remains strong. In fact, if you take away the impact of the tech giants, namely Facebook, Apple, Amazon, Microsoft and Google, the headline index would be a little more than 3% lower (Chart 13).

13 Five tech giants responsible for 20% of S&P 500 YTD returns!

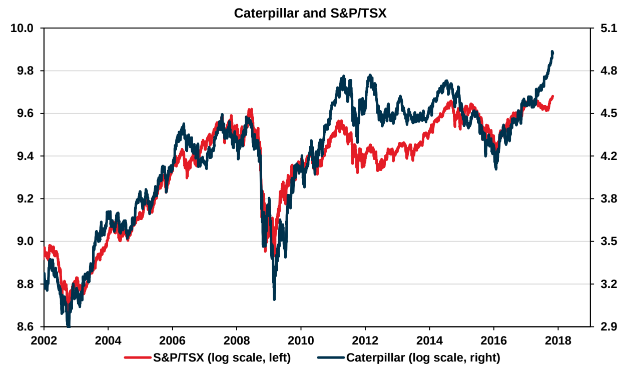


Source: CIO Office, Datastream
*Tech giants = Capitalisation weighted index of Facebook, Amazon, Alphabet (Google), Microsoft and Apple

To put it differently, it means that these five stocks (out of 505 constituents) are responsible for over 1/5 of 2017 YTD performance, making the U.S. equity benchmark more vulnerable to pullbacks from any one of the blockbuster names. Still, it would be unfair to put all the responsibility of U.S. equity leadership over Canada on the backs of tech heavyweights, as most S&P 500 sectors are up double digit YTD, with the exception of Telecom, Energy and Staples.

For instance, among the long list of U.S. stocks up double digits so far this year hides an industrial company acting as a good proxy for global growth: Caterpillar (US:CAT). Indeed, the heavy equipment company (up 46% YTD) crushed its Q3 earnings estimates, citing solid growth notably in Chinese construction and the North American oil and gas industry. This single stock is interesting for the fact that it has historically been highly correlated to Canada's main equity benchmark given that they both share a large reliance on global growth, mining activity, and oil and gas investments (Chart 14).

14 Surging CAT bodes well for Canada

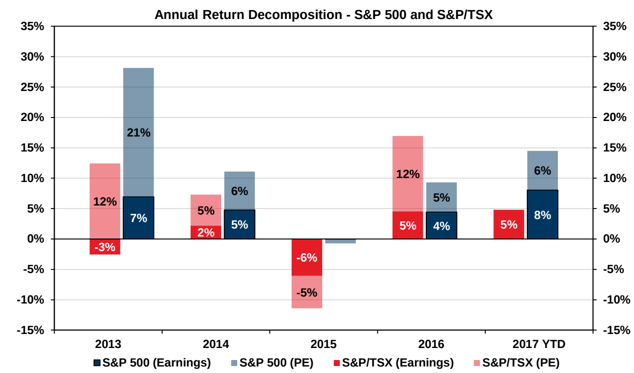


Source: CIO Office, Datastream

It is debatable whether CAT's run is overdone, but it remains true that the S&P/TSX is a better option when it comes to cyclical exposure, and Caterpillar's earnings results bear witness to the strength in the world economy.

Separating equity returns between forward earnings growth and PE expansion also paints a picture in favour of the Canadian index, as 100% of the S&P/TSX 2017 performance was propelled by earnings growth (Chart 15). Indeed, the country's price index and forward earnings expectations are both up 5% YTD, hence why its PE ratio remains at par with early 2017 levels at 16.33x. On the other hand, the S&P 500 might be up 14% YTD, but that performance implies a 6% forward PE expansion, with its valuation ratio currently sitting at 18.20x. In other words, the race between the two neighbours is much closer from a fundamental point of view, and we believe that the valuation gap continues to depict a better risk-reward profile north of the border.

15 The race is much closer from a fundamental point of view



Source: CIO Office, Datastream

In short, the tug of war between the two benchmarks continues, with no clear leader since we overweighed Canadian equities in late June. We keep our positioning unchanged this month, although the recent shift in economic momentum in favour of the U.S. must be closely monitored.