INVESTING

Asset Allocation Strategy

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Reflation 2.0?

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Highlights

- At this point in the economic and monetary policy cycle, we believe the S&P/TSX tilt toward pro-cyclical, value companies makes it a good candidate for outperformance. Therefore, we stick to our overweight Canadian equities stance. We also took advantage of the solid outperformance from our currency hedged U.S. investment-grade bonds position to lock-in profits and move fixed-income assets back into the equity market, gradually increasing our exposure to the asset class, and thereby getting back to neutral in U.S. and EAFE equities.
- For crude oil, our base case scenario of a long and gradual increase in prices remains intact. The market seems to be witnessing a self-correcting equilibrium where a soft floor on levels is maintained by OPEC while any spike will be swiftly met with increased production in the U.S.
- As inflation is a lagging indicator of the cycle, the sharp acceleration in economic activity that was recorded during the second half of 2016 should gradually give way to an increase in inflationary pressures. As such, we believe the path of least resistance for interest rates is up. In our opinion, non-traditional fixed-income strategies will outperform in the near term and we favour an allocation of global bonds (higher yield to maturity) mixed with credit spreads (without taking duration risk).
- While Fed Chair Yellen has re-calibrated expectations regarding a hike in December to a near-certainty, we believe the medium-term market projections for a hike are still too low. The scenario where the FOMC is more hawkish than expected or the ECB less aggressive than initially assumed is more probable than the contrary. Consequently, we believe the overall bull market for the greenback is not over and might have more room to run.
- Central bank actions are always dependent on the economic situation and, on that front, it seems that expectations for Canada are too high, while the U.S. is set to turn a corner. This puts the loonie in a situation where it could tactically weaken on the short-term horizon. As such, we suggest removing a part of the hedge in your investments south of the border.

Table 1 Global Asset Allocation

Global Classes	– Weights (1)	(2)	(3)	(4)	+ (5)
Cash			Current		
Fixed Income		Current	Previous		
Equities			Previous	Current	
Fixed Income					
Federal		Current			
Investment Grade			Current	Previous	
High Yield (USD)			Current		
Non-Traditional FI				Current	
World Equities					
S&P/TSX				Current	
S&P 500 (USD)		Previous	Current		
Growth vs. Value		Current	Previous		
Large vs Small cap.			Current	Previous	
Defensives vs Cyclicals		Current	Previous		
MSCI EAFE (USD)			Current	Previous	
MSCI EM (USD)		Current			
Alternative Investments					
Currency Hedge		Current	Previous		
Commodities			Previous	Current	
Energy			Previous	Current	
Base Metals			Current		
Gold			Current		
Hedge Funds			Current		
Infrastructure			Current		

Source: Consulting Investment Committee

Current Allocation
Previous Month Allocation

Market review

Fixed income

- U.S. treasury rates perked up amid FED Chair Yellen remarks supportive of a December rate rise and Trump's tax reform coming back to the fore. Indeed, the yield on the 10-year benchmark closed 20bps higher than the August close.
- Despite modestly relapsing in the last few days of the month with dovish comments by Governor Poloz and a flat GDP print for July, 10-year Canadian government rates finished 25bps higher as the Central Bank decided to raise its overnight rate to 1 per cent September 6th.

Canadian equities

- The S&P/TSX stood out in September, outpacing its U.S counterpart with a 3.1% monthly gain, pushing the Canadian benchmark to a 4-month high.
- Energy stocks ran the show, helped by a sharp rise in oil prices, and followed by Discretionary, Healthcare, Financials and Industrials companies as sentiment favored cyclical sectors.

U.S. equities

- Republicans' tax reform proposal have helped propel the S&P 500 to a new record high as the index posted a positive monthly performance for the sixth month in a row.
- Gains were powered by a rally in financials stocks and the resurgence of the energy sector.
- Technology shares took a breather in September, little changed compared to a month earlier but still ahead of the pack year-to-date, up 27%.

Commodities

- Tensions in the Kurdistan region after a vote in favor of independence sent oil prices higher, with the WTI benchmark settling above the $50 mark.
- Risk-on sentiment wasn't supportive of gold prices as investors looked past the North Korean rhetoric, off 2.4% in September.

Foreign exchange

- The U.S. dollar index broke a 6-month string of consecutive monthly declines, closing a nudge higher on the back of a more hawkish stance from the Federal Reserve and hope for U.S. tax cuts.
- After rallying vigorously in the aftermath of the Bank of Canada rate hike early in September, the loonie showed some exhaustion with Governor Poloz tempering recent optimism surrounding the Canadian economy.

Table 2 Market Returns

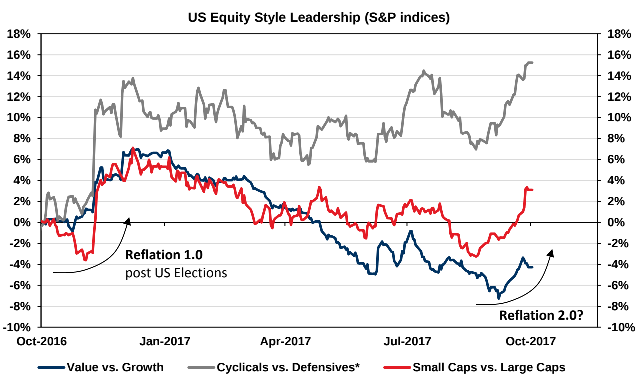
Asset classes	September	YTD	2016
Cash (3-month T-bills)	0.0%	0.3%	0.5%
Bonds (FTSE/TMX Ovr. Univ.)	**-1.3%**	**0.5%**	**1.7%**
FTSE/TMX Short term	-0.5%	-0.2%	1.0%
FTSE/TMX Mid term	-1.3%	-0.2%	1.6%
FTSE/TMX Long term	-2.6%	1.7%	2.5%
FTSE/TMX Government	-1.4%	0.1%	0.9%
Federal	-1.2%	-0.7%	0.0%
Provinces	-1.7%	0.9%	1.8%
Municipales	-1.4%	1.6%	2.0%
FTSE/TMX Corporate	-1.1%	1.5%	3.7%
AA+	-0.6%	0.3%	2.0%
A	-1.3%	2.1%	3.6%
BBB	-1.1%	1.9%	5.1%
BoAML High-Yield (USD)	0.9%	7.0%	17.5%
Preferred shares	1.4%	10.6%	7.0%
Canadian Equities (S&P/TSX)	**3.1%**	**4.4%**	**21.1%**
Energy	7.7%	-7.6%	35.5%
Industrials	3.7%	14.7%	22.8%
Financials	3.9%	7.2%	24.1%
Materials	-3.8%	2.5%	41.2%
Utilities	-2.0%	7.9%	17.7%
Cons. Disc	5.6%	17.4%	10.7%
Cons. Staples	-0.1%	1.5%	7.5%
Healthcare	5.3%	-8.5%	-78.4%
IT	2.8%	12.9%	5.2%
Telecom	-0.2%	10.1%	14.7%
REITs	-0.7%	4.9%	9.1%
S&P/TSX Small cap	2.1%	-1.9%	38.5%
US Equities (S&P500 / USD)	**2.1%**	**14.2%**	**12.0%**
Energy	9.9%	-6.6%	27.4%
Industrials	4.0%	14.1%	18.9%
Financials	5.1%	12.5%	22.8%
Materials	3.5%	15.8%	16.7%
Utilities	-2.7%	11.9%	16.3%
Cons. Disc	0.8%	11.9%	6.0%
Cons. Staples	-0.9%	6.6%	5.4%
Healthcare	1.0%	20.3%	-2.7%
IT	0.6%	27.4%	13.8%
Telecom	3.5%	-4.7%	23.5%
REITs	-1.4%	7.4%	3.4%
Russell 2000 (USD)	6.1%	9.9%	19.5%
World eq. (MSCI ACWI)	**2.0%**	**17.8%**	**8.5%**
MSCI EAFE (USD)	2.5%	20.5%	1.5%
MSCI EM (USD)	-0.4%	28.1%	11.6%
Commodities (CRB index)	**-1.9%**	**1.0%**	**12.9%**
WTI oil (US$/barrel)	9.3%	-3.9%	44.8%
Gold (US$/ounce)	-2.4%	10.9%	9.0%
Copper (US$/tonne)	-4.8%	16.5%	17.4%
Forex (DXY - US Dollar index)	**0.4%**	**-8.9%**	**3.6%**
USD per EUR	-0.6%	12.1%	-2.9%
CAD per USD	-0.1%	-7.2%	-2.9%

Source: Datastream 2017-09-29

Equities: Diverging neighbors

Equity leadership reconnected with the global economic upswing in September, looking past the volley of threats between the U.S. and North Korea as cyclical sectors clawed back some of their recent underperformance against defensive equities. The combination of lower-than-expected damages from hurricanes, continued strength in economic data, and a sense that Congress is increasingly focusing on delivering tax reforms was also conducive to a rebound from small cap stocks, recouping a fraction of the ground lost to larger companies year-to-date (Chart 1).

Reflation 2.0?

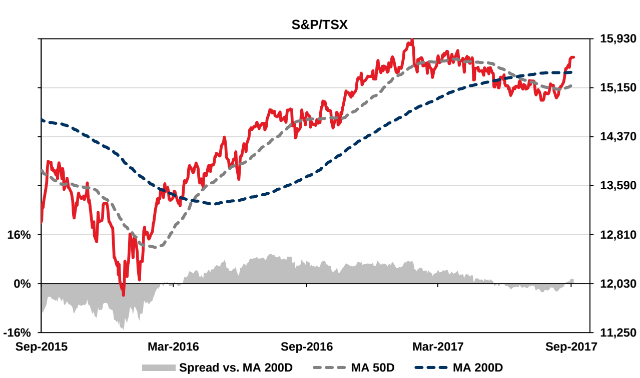


Source: Datastream. *Cyclicals = Energy, Financials, Materials. *Defensive = Staples, Telecom, Utilities

1

Classic late-cycle behavior (rising bond yields and commodity prices) as seen lately, usually benefits the S&P/TSX given its heavy bias toward top cyclical sectors (Energy and Financials). And indeed, the Canadian index stood out, surging swiftly above both its 50-day and 200-day moving averages (Chart 2).

S&P/TSX surging swiftly above its key moving averages

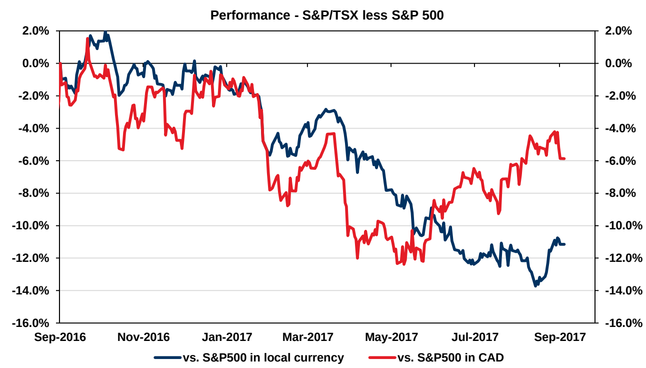


Source: Datastream

2

Back in July, we initiated our recommendation to overweight Canadian equities against their U.S. counterparts on the back of an improving macro backdrop this side of the border and a better risk-reward profile value-wise. While this positioning has greatly benefitted from loonie strength since then, the S&P/TSX hasn't managed to gain leadership on a local currency basis (Chart 3).

Canadian vs. US equities: Two currencies, two stories

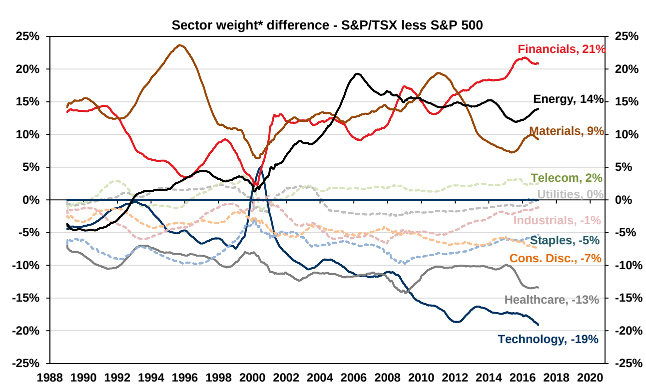


Source: Datastream

3

The fact of the matter is that over the last three decades, both the S&P 500 and S&P/TSX have taken drastically opposite directions in terms of sector allocation, the former towards growth/defensive sectors (Healthcare, Technology) and the latter in favour of value/cyclical sectors (Financials, Energy). From an asset allocation standpoint, taking cash out of the U.S. equity market into Canada is roughly the equivalent of being long on Financials (+21%), Energy (+14%) and Materials (+9%) against a short position in Healthcare (-13%) and Technology (-19%) (chart 4). The evolution of the relative technology and healthcare weights illustrates how increasingly absent these sectors are in Canada, with Nortel being a thing of the past and Valeant now worth only 1/20 of its July 2015 peak market cap. The lack of Canadian tech darlings and healthcare stocks has been and will continue to be a challenge for the country's index as long as appetite for expected growth with fewer concerns for valuations remains strong. To put it in another way, the TSX vs. S&P 500 trade has increasingly become a Value vs. Growth one

Diverging neighbours sector-wise

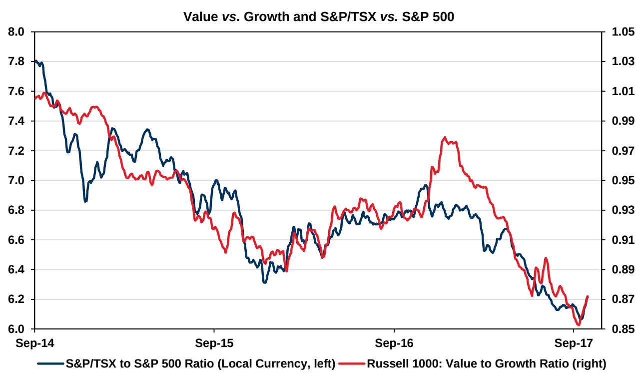


Source: Datastream *Weights are calculated with a linear regression (rollling 20 days window) and illustrated with their 200-day moving average.

4

(Chart 5). To be more specific, Energy shares need to regain some leadership against Technology for the S&P/TSX to really distance itself from its southern neighbor. The good news is that the relative valuation gap between the two sectors suggests that the odds of such a scenario are increasing (Chart 6). Indeed, the previous two occasions (1983, 2000) where North American Energy traded at a similar discount to Tech stocks from a Price-to-Book standpoint (currently 64% cheaper) preceded a strong rotation in favor of Oil & Gas companies.

Canadian vs. US equities… Or value vs. growth?



Source: Datastream
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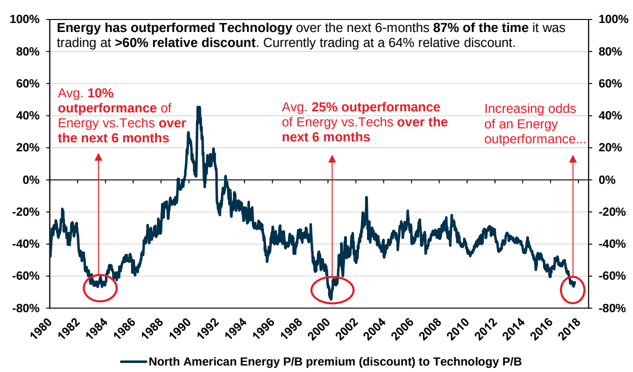
Extreme valuation gap between energy and tech stocks

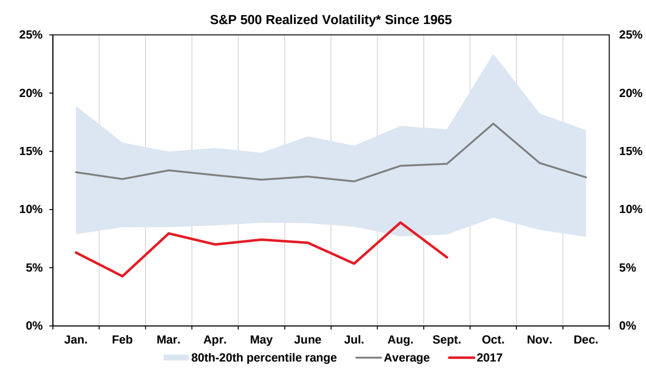


Source: Datastream
6

At this point in the economic and monetary policy cycle, we believe the S&P/TSX tilt toward pro-cyclical, value companies makes it a good candidate for outperformance, with bond yields expected to rise (favoring Financials) and the broad-based economic upswing persisting (favoring Materials and Energy). Therefore, we stick to our overweight Canadian equities stance. We also took advantage of the solid outperformance from our -currency hedged U.S. investment-grade bonds position to lock-in profits and move fixed-income assets back into the equity market (see fixed-income section), gradually increasing our exposure to the asset class, and thereby getting back to neutral in U.S. and EAFE equities. From a currency standpoint, this positioning purposely results in a long U.S. dollar exposure as we believe the greenback short-term risks are skewed to the upside (see currencies section).

Finally, it should be noted that equity markets have been extraordinarily calm this year, exhibiting a meager 7.0% volatility* year-to-date with investors becoming accustomed to political uncertainty. Nevertheless, if history is any guide, seasonality points to a potential pick up in volatility this month (Chart 7). True, the October 18th China National People's Congress, the October 26th ECB tapering decision, and escalating tensions between U.S. and North Korean leaders could feed uncertainty but we reiterate that our focus remains on the healthy macro backdrop, which helps cyclical assets, hence why we modestly increase our equity exposure.

Seasonality points to a potential pick up in volatility



Source: Datastream *Volatility measured by the annualized standard-deviation of daily returns observed during the month..
7

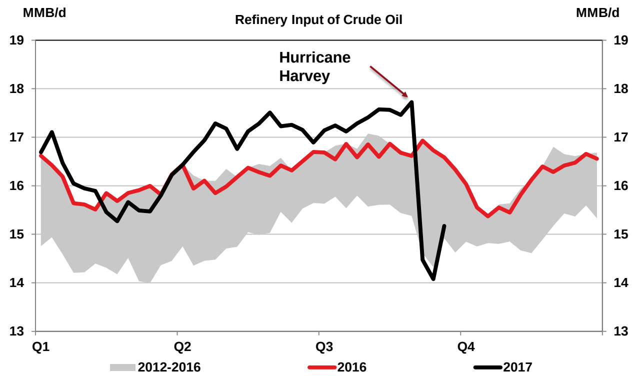
Commodities: In a self-correcting equilibrium

The impact from hurricanes Harvey and Irma still needs to be fully assessed but for now inventory builds have been lower than initially expected and offset by diesel and gasoline draws, which should translate to higher demand for oil down the road.

Refineries are already in recovery mode, but maintenance season is starting soon in preparation for the uptick in activity for winter diesel demand. As such, the shutdowns due to Harvey have given companies a golden opportunity to advance the maintenance schedule by a couple of weeks (Chart 8). The net effect of all of this upheaval should be close to neutral as energy consumption picks up in tandem with recovery efforts.

While all eyes were on the hurricane's effects, the supply and demand picture finally dipped into deficit territory, a first since 2014 (Chart 9). A strong appetite for energy products, spurred by synchronized global economic vigor, added to OPEC cuts have

The recovery has already begun



Source: Datastream
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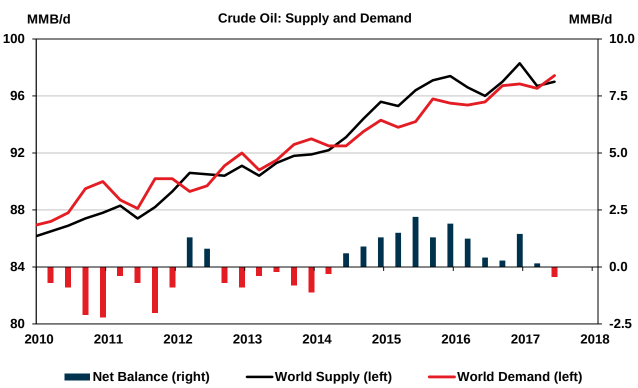
A long-awaited deficit

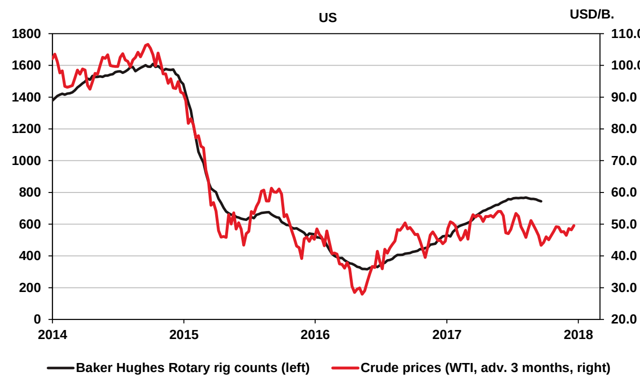


Source: Datastream
9

finally killed surpluses. The Cartel is expected to announce an extension of the cuts through the March 2018 deadline, but investors will focus on whether or not Libya and Nigeria will be brought into the fold. The two countries have surprised markets with strong production gains in recent quarters, which have put a dent in OPEC's power to implement its objectives. The probability of such an occurrence remains low for now, but a surprise on that front would surely translate to higher crude prices.

Despite OPEC and hurricane headlines, shale oil remains the elephant in the room. As we discussed in previous newsletters, the lower crude levels have affected U.S. activity in the last quarters as rig counts have stalled (Chart 10). This bodes well for next year as the low lying fruit has been harvested and the marginal production cost of $40 a barrel should slowly ramp up as less attractive wells are drilled. The fact that production growth has somewhat tapered is a sign that energy prices have reached a "sweet spot" where profit margins can be affected with a crude drop.

Is 50$ the "sweet spot" for producer profit-margins?



Source: Datastream
10

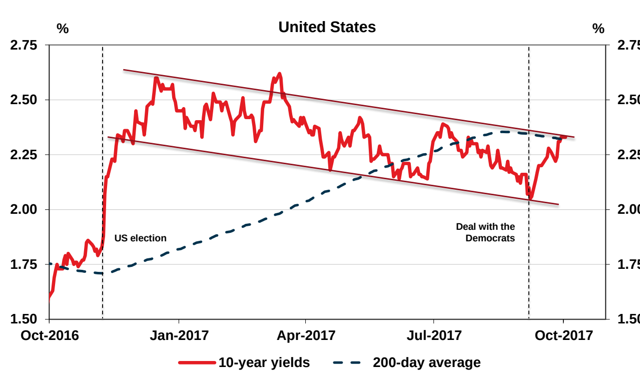
Going forward, our base case scenario of a long and gradual increase in prices remains intact. The market seems to be witnessing a self-correcting equilibrium where a soft floor on levels is maintained by OPEC while any spike will be swiftly met with increased production in the U.S. The cartel would also take advantage of the situation to implement an exit strategy from its production cut agreement.

Fixed Income: Fighting the trend

Although inflation remains below expectations, yields finally rebounded from a year-to-date intraday low of 2% on September 8, as Trump's deal with the Democrats aiming to extend the debt ceiling until December and provide $15.25B USD for hurricane disaster aid helped ease some of the near term uncertainties (Chart 11).

Later on, yields benefitted from additional tailwinds from the Fed. The confirmation that the Central Bank would start reversing its bond purchase program in October was widely expected. But, market participants were caught off guard by the

Bond yields: Make or Break?



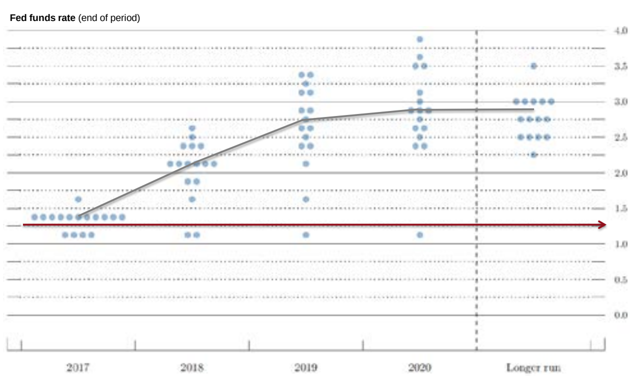
Source: Datastream
11

FOMC's implied rate path which suggests the majority of voting members still think a hike before year-end will be necessary (Chart 12). Fed Chair Yellen confirmed as much in a speech about a week later where she left no doubt about the Fed's intention to carry on with their gradual monetary tightening, sooner rather than later:

> *"A gradual approach is particularly appropriate in light of subdued inflation and a low neutral interest rate, [but] without further modest increases in the federal funds rate over time, there is a risk that the labor market could eventually become overheated. For [this] reason, and given that monetary policy affects economic activity and inflation with a substantial lag, it would be imprudent to keep monetary policy on hold until inflation is back to 2 percent."*

-Janet Yellen, Sept. 26, 2017

Vote intentions by FOMC members

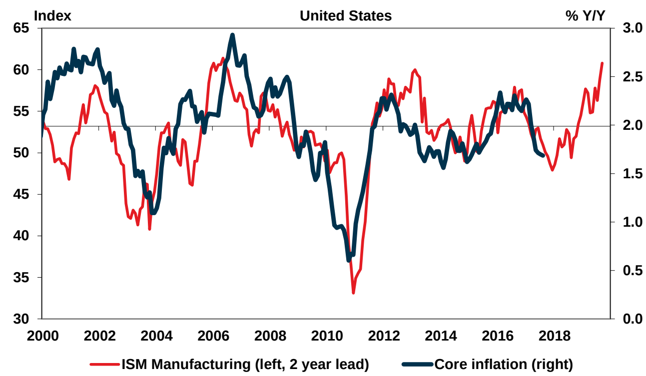


Source: Federal Reserve
12

Concerning inflation, the fall in energy prices and some adjustments to health care products have exerted downward pressure recently, but they are one-off events that should only have a transitory impact on prices. Instead, as inflation is a lagging indicator of the cycle, the sharp acceleration in economic activity that was recorded during the second half of 2016 should gradually give way to an increase in inflationary pressures (Chart 13).

As such, we believe the path of least resistance for interest rates is up. We still like investment grade credit, but there isn't as much space to benefit from the positive carry in the U.S. market now that the curve structure in Canada has caught up to its American counterpart. In our opinion, non-traditional fixed-income strategies will outperform in the near term and we favour an allocation of global bonds (higher yield to maturity) mixed with credit spreads (without taking additional duration risk).

Leading indicator points towards a pick-up in inflation



Source: Datastream
13

Currencies: Calibrating expectations

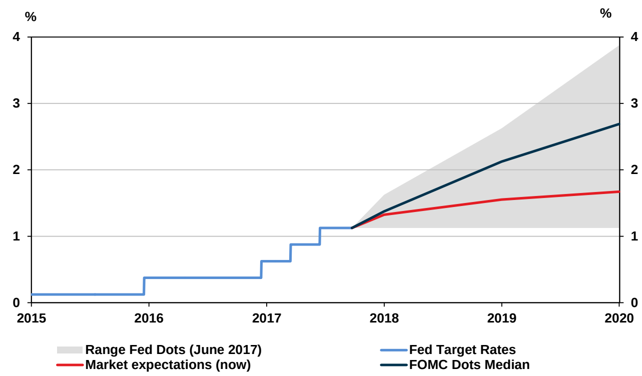
For the most part of 2017, the U.S. dollar has fallen victim to multiple factors:

1. The pessimistic view about U.S. economic growth and policy outlook, while the rest of the world seems to be entering a phase of synchronized pick-up in activity.
2. The constant impression that the Fed would remain dovish for the foreseeable future, as inflation keeps falling short of the Central Bank's expectations.
3. Increasingly bearish speculative positioning.

Some of these points are valid. However, as we discussed in the fixed-income section, we believe a turn for inflation is around the corner. The uncertainty regarding Trump's tax plan and its potential expansionary effect still need some clarity, but the President and Congress have a strong incentive to show something tangible to voters before the mid-term elections. As such, we think there's a much better chance a watered-down version of this plan is passed compared to previous initiatives.

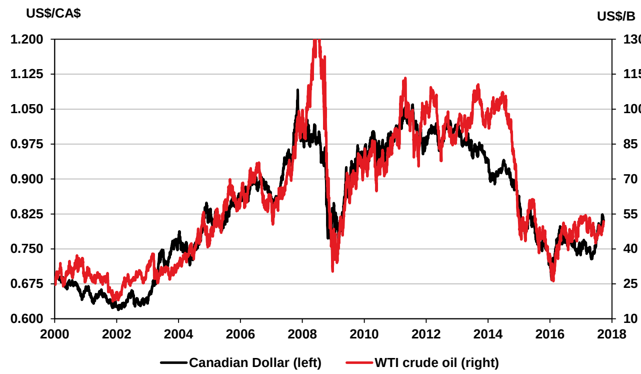
The market's hopes regarding the ECB's removal of policy accommodation has weighed-in on the dollar. While Fed Chair Yellen has re-calibrated expectations regarding a hike in December to a near-certainty, we believe the medium-term market projections for a hike are still too low (Chart 14). The scenario where the FOMC is more hawkish than expected or the ECB less aggressive than initially assumed is more probable than the contrary. Consequently, we believe the overall bull market for the greenback is not over and might have more room to run.

Markets expects 2 less hikes than the Fed for 2018



Source: Datastream
14

Crude volatility usually translates to loonie movements…



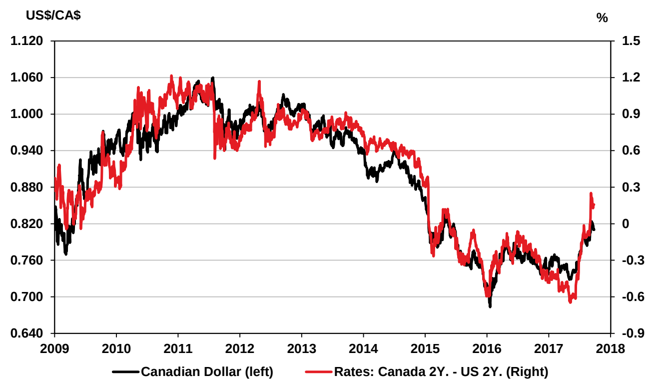
Source: Datastream
15

For the loonie, performances generally tie in well to crude oil swings (Chart 15), which is normal when a large part of the country's economic fortunes are dependent on the product. However, rate differentials between the countries have a much higher correlation to the currency pair's value (Char 16). It is usually well correlated to energy prices, unless there's a divergence of monetary policy --- a situation we witnessed in the 2010-2011 period and, more recently, when the Fed was hiking while the BoC was dealing with the crude oil drop (Chart 17).

As those transitory effects started to fade the Central Bank entered upon a hike path, but the enthusiasm regarding future actions from Mr. Poloz was moderated in light of a recent speech he made about monetary policy:

> *"The economic progress we have seen tells us that the moves we took to ease policy in 2015 were the right thing to do. At a minimum, that additional stimulus is no longer needed. But there is no predetermined path for interest rates from here. Monetary policy will be particularly data dependent in these circumstances and, as always, we could still be surprised in either direction."*
>
> -Stephen S. Poloz, September 27, 2017, St. John's Board of Trade

… but rate differentials also make a strong point



Source: Datastream
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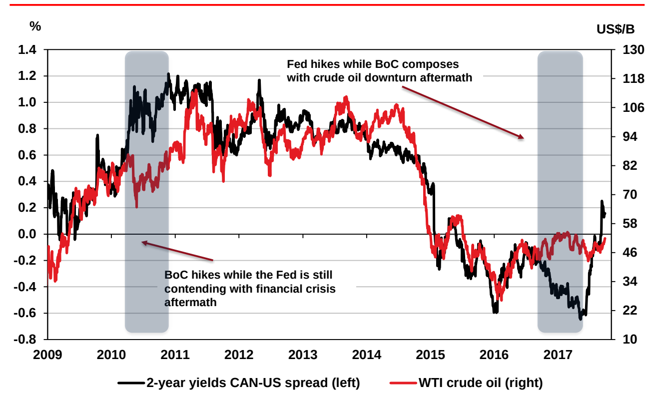
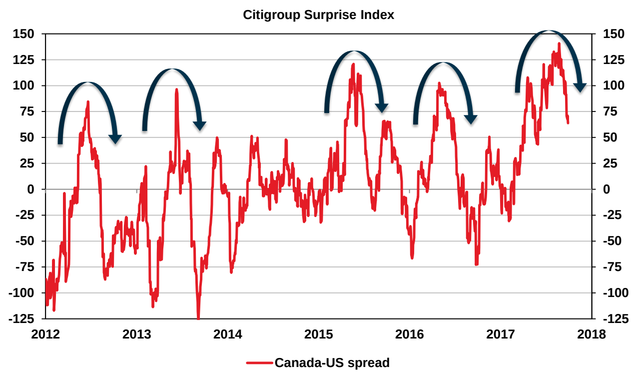
Crude = rate differentials… unless there's policy divergence



Source: Datastream
17

Central bank actions are always dependent on the economic situation and, on that front, it seems that expectations for Canada are too high, while the U.S. is set to turn a corner (Chart 18). This puts the loonie in a situation where it could tactically weaken on the short-term horizon. As such, we suggest removing a part of the hedge in your investments south of the border.

Have expectations set Canada up to fail?



Source: Datastream
18