INVESTING

Asset Allocation Strategy

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Government shutdown: full of hot air?

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Highlights

- As long as central bankers stick to the prudent monetary policy normalization path currently priced-in, equities should remain resilient regardless of the political circus coming out of Washington. Still, we believe better entry points lie ahead as we distance ourselves from the low volume summer months. As such, we maintain our neutral stance on the asset class.
- We believe the hurricane news are bearish for crude on the short-term horizon. We expect fundamentals to slightly worsen in light of refinery shutdown and reduced demand for energy products as the area is recovering. If refinery outages persist because of refining infrastructure damage, the supply and demand picture could materially worsen on the medium-term horizon and drag oil prices further down, despite gasoline prices shooting up.
- While it's undeniable the trend is pointing down for the greenback, some short-term forces could put a pause on the momentum. Technically, the DXY is rebounding on a support level. Speculative positioning, while still not at record levels, is now in short territory, a first since 2014. These factors should not be ignored, as they could have a sizeable effect on the short-term performance of the currency.
- The reverse is true for the loonie. While growth is gaining momentum and our economic department still believes an interest rate hike is in the cards for October, speculative money is starting to tilt more and more on the long side.
- We believe yields should re-test their long-term trend on the upside sometime before year end. However, with a potential for lower oil prices, we suggest keeping a neutral duration approach for the time being. In the eventuality of weaker crude prices, credit spreads could continue to deteriorate, but as in the 2014/2015 downturn, this should remain mostly concentrated in the energy sector.

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 ▨

NATIONAL BANK

Market review

Fixed income

- U.S. 10-year benchmark has been under pressure in August amid concerns over the North Korean saga and Hurricane Harvey landfall, giving away 17 bps.
- Canadian rates followed a similar course, shedding 20 bps compared to last month. Nonetheless, odds of a Bank of Canada hike by October climbed to 80% on August 31 after data showed GDP grew at a stunning 4% annualized in the first half of the year, its fastest pace in nearly 6 years.

Canadian equities

- The S&P/TSX ended slightly positive despite starting off on the wrong foot as geopolitics rattled risk appetite.
- Soft energy stocks (19% index weight) hobbled the benchmark, but the move was partly offset by a continued rally in copper prices, sending materials shares 5.5% higher in August.

U.S. equities

- Despite a tumultuous few days, the S&P 500 finished inches above last month's close, an outcome partly due to solid gains in Technology stocks (23% of the index).

Commodities

- Gold prices climbed 3.7% compared to July close, reaching an 11-month high on August 28 with the latest Pyongyang missile launch sparking a rush into haven assets.
- Oil prices came under pressure in the wake of Hurricane Harvey. WTI (U.S. benchmark) suffered the most, down 5.9% with crude supply continuing to accumulate in Cushing.
- Gasoline price action is also worth mentioning, surging 20% as the outlook for supply dimmed in light of refinery shutdowns.

Foreign exchange

- After a buoyant start, the U.S. Dollar index relapsed, failing to halt a 5-month slide as it closed inches below last month's levels.
- In Canada, after softening 2% during the first half of August, the loonie managed to reverse course and close roughly unchanged, helped by GDP growth numbers persistently beating estimates.

Table 2 Market Returns

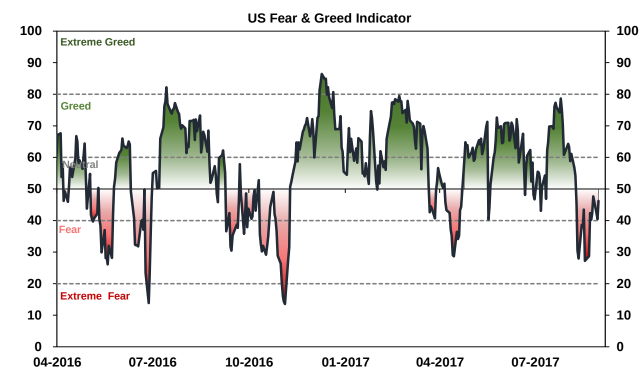
Asset classes	August	YTD	2016
Cash (3-month T-bills)	0.1%	0.3%	0.5%
Bonds (FTSE/TMX Ovr. Univ.)	**1.4%**	**1.8%**	**1.7%**
FTSE/TMX Short term	0.4%	0.3%	1.0%
FTSE/TMX Mid term	1.4%	1.2%	1.6%
FTSE/TMX Long term	2.9%	4.4%	2.5%
FTSE/TMX Government	1.5%	1.5%	0.9%
Federal	1.2%	0.5%	0.0%
Provinces	1.8%	2.6%	1.8%
Municipales	1.7%	3.1%	2.0%
FTSE/TMX Corporate	1.1%	2.6%	3.7%
AA+	0.6%	0.8%	2.0%
A	1.3%	3.4%	3.6%
BBB	1.2%	3.1%	5.1%
BoAML High-Yield (USD)	0.0%	6.1%	17.5%
Preferred shares	-0.7%	9.1%	7.0%
Canadian Equities (S&P/TSX)	**0.7%**	**1.3%**	**21.1%**
Energy	-3.1%	-14.2%	35.5%
Industrials	3.1%	10.6%	22.8%
Financials	0.3%	3.1%	24.1%
Materials	5.5%	6.6%	41.2%
Utilities	2.0%	10.1%	17.7%
Cons. Disc	1.9%	11.2%	10.7%
Cons. Staples	0.5%	1.6%	7.5%
Healthcare	-10.2%	-13.1%	-78.4%
IT	1.6%	9.8%	5.2%
Telecom	1.0%	10.4%	14.7%
REITs	1.7%	5.6%	9.1%
S&P/TSX Small cap	0.3%	-3.8%	38.5%
US Equities (S&P500 / USD)	**0.3%**	**11.9%**	**12.0%**
Energy	-5.2%	-15.1%	27.4%
Industrials	0.2%	9.7%	18.9%
Financials	-1.6%	7.0%	22.8%
Materials	0.9%	11.9%	16.7%
Utilities	3.3%	15.0%	16.3%
Cons. Disc	-1.8%	11.0%	6.0%
Cons. Staples	-1.1%	7.5%	5.4%
Healthcare	1.8%	19.1%	-2.7%
IT	3.5%	26.6%	13.8%
Telecom	-3.0%	-7.9%	23.5%
REITs	1.1%	8.9%	3.4%
Russell 2000 (USD)	-1.4%	3.5%	19.5%
World eq. (MSCI ACWI)	**0.4%**	**15.5%**	**8.5%**
MSCI EAFE (USD)	0.0%	17.5%	1.5%
MSCI EM (USD)	2.3%	28.6%	11.6%
Commodities (CRB index)	**-1.4%**	**3.0%**	**12.9%**
WTI oil (US$/barrel)	-5.9%	-12.1%	44.8%
Gold (US$/ounce)	3.7%	13.7%	9.0%
Copper (US$/tonne)	6.7%	22.4%	17.4%
Forex (DXY - US Dollar index)	**-0.2%**	**-9.3%**	**3.6%**
USD per EUR	0.8%	12.7%	-2.9%
CAD per USD	0.0%	-7.1%	-2.9%

Source: Datastream 8/31/2017

Equities: U.S. Budget Brawl Ahead

After one of the calmest stretches for equities in decades, late summer markets came under pressure in light of an escalating war of words between North Korea and the White House. With investors piling into Put options and the VIX closing above the 16 mark for the first time in 4 months, we saw our Fear & Greed indicator dip into fear territory early in August, before reverting back to neutral later in the month (Chart 1).

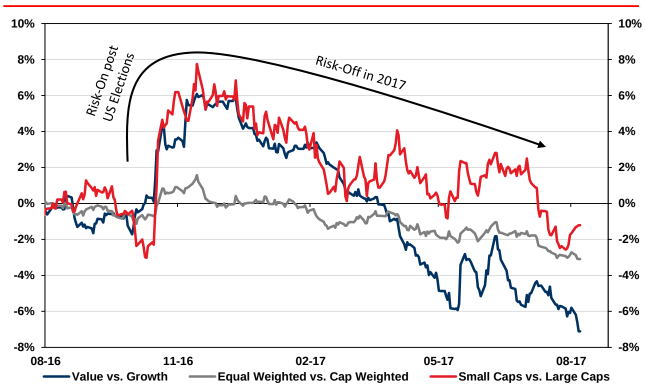
Geopolitical anxiety struck markets in August



Source: Bloomberg
1

As such, it's no surprise to see equity leadership continuing to illustrate a clear tendency for safer assets (Chart 2). Indeed, the sharp risk-on move that followed the U.S. elections has gradually reversed through 2017 as Small Cap and Value stocks more than erased their relative outperformance in favour of Large Cap and Growth equities. Diminishing market breath, illustrated by the Equal Weight underperformance, also portrays a market that is losing steam.

Risk-off leadership in 2017



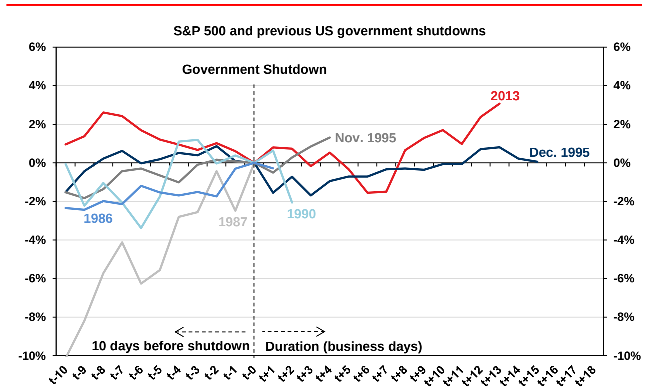
Source: Datastream
2

Where we go from here remains to be seen. The risks out of Washington will most likely continue to dominate the headlines. President Trump is already clear on his intention to leverage a potential government shutdown in the debt ceiling and spending deadline debate, set to start when Congress returns from recess on September 5th. To avoid a government shutdown, Congress will have to approve an extension of the debt ceiling before September 29, and a spending bill by September 30. The focus will likely be on the latter as Congress will have to discuss highly contentious immigration, healthcare and fiscal policies. With very little support for the border wall, inner fights within the GOP, and Trump's incentives to please his declining base, we find it hard to believe that the Hill will manage to pass a bill that captures the required 218 votes, on time and without a hitch. Moreover, despite a Republican-controlled White House and Congress, Democratic votes will be necessary and are likely to come with their own demands.

Nevertheless, Republican leaders have little to gain from failing to reach an agreement. With Hurricane Harvey refusing to let up, there's a growing probability that Congress will pass a debt ceiling increase and a short-term continuing resolution, together with an emergency relief package to help the people of Texas. Not only would that option extend the budget deadline through to approximately mid-December, but it would also give Republicans a window to focus on tax reform, something that they've been quite vocal about lately.

Two main conclusions can be drawn from previous government shutdowns. First, they're usually quite short (median of 3 days since 1981), although recent shutdowns have lasted longer (16 days in 2013). Second, the impact on equity markets has been fairly limited and inconsistent. However, an increase in volatility would be expected in such a scenario (chart 3 and 4). Effects on the economy would also be marginal, coming in the form of reduced work hours for the federal employees concerned (40% of the government workforce, or approximately 800k jobs). This number usually quickly shrinks down as executive branch departments gradually receive their annual appropriations. Elevated valuations and an aging bull market certainly make it more vulnerable to corrections, but our focus remains on the macro backdrop, which continues to favor equities.

Little impact from previous government shutdowns



Source: Datastream
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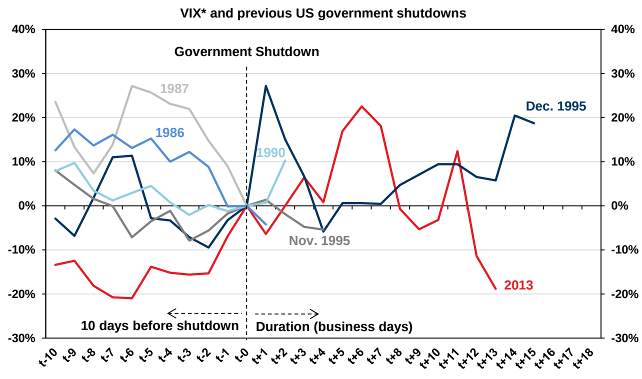

Source: Datastream, CBOE (*VXO Index used before 1990)
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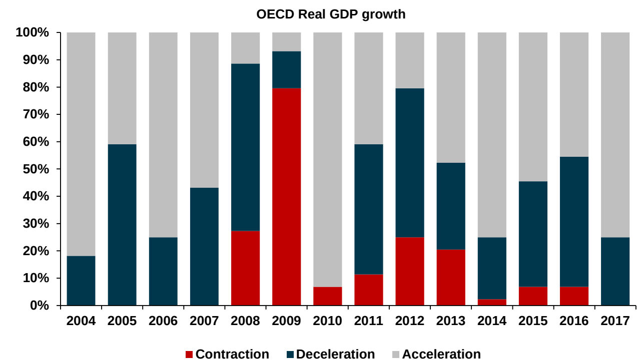
Synchronised expansion visible in GDP numbers



Source: Datastream
5

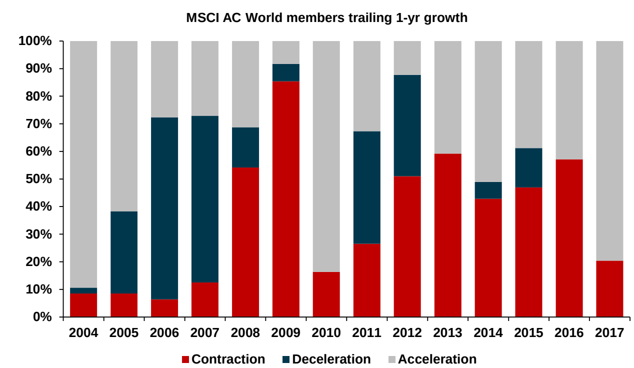
Although U.S. leading economic indicators continue to point upward, global growth might not rely as much on the U.S. as previously seen. Indeed, the 2017 synchronized upturn lingers on, with all 44 OECD countries exhibiting real GDP growth (Chart 5) – for the first time in a decade. This has also translated into improving company fundamentals globally, with trailing 12-month earnings accelerating in 80% of the countries covered by MSCI indexes, adding to evidence that countries are increasingly running in lockstep (Chart 6).

The bottom line in this context is clear. As long as central bankers stick to the prudent monetary policy normalization path currently priced-in (as suggested by their avoidance of the subject at the economic symposium at Jackson Hole in late August), equities should remain resilient regardless of the political circus coming out of Washington. Still, we believe better entry points lie ahead as we distance ourselves from the low volume summer months. As such, we maintain our neutral stance on the asset class. We also stick to our bias in favour of Canadian equities against their U.S. counterparts. This positioning continues to benefit from a stronger loonie, reflecting the improving Canadian economic data element of our investment thesis. Despite the potential downward drag from oil prices (see Commodities section), the S&P/TSX risk-reward profile still compares well against the S&P 500 in an environment where economic momentum gradually spreads into corporate profits, as suggested by the strength of the latest quarterly results from the heavily weighted Canadian banks

Commodities: The Devil is in the Details

Hurricane Harvey hit the Texas coast on August 25, bringing with it heaving rains and widespread flooding. Texas is synonymous with crude and we are still not clear on the extent of the damage throughout the area. In light of this event, one normally expects energy levels to materially increase when a natural disaster hits a production area, but oil prices dropped on the news… what

…and realised corporate earnings globally*



Source: Datastream
*Covers all 50 countries part of the MSCI AC World index except Venezuela
6

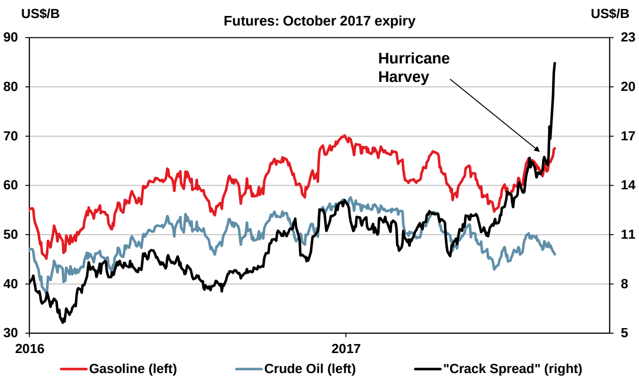
happened? As usual the situation is more complex than meets the eye:

1- The path of the hurricane covered an area with a large concentration of refineries, but bypassed the bulk of the offshore crude production centres. Consequently, refinery margins, which are represented by the gasoline and diesel spreads to oil (also known as "crack spreads") shot up (chart 7). At the start of the week, it was estimated that close to 15% (2.5 to 3 million barrels per day) of the U.S. refining capacity was affected while only around 10% of crude production was offline (1 million barrels per day). The difference in impact between the two is non-negligible and therefore reduces the demand for oil.

2- Recovery from such events usually takes much longer for refineries than wells. For now, most of the closings are preventive in nature and, while we are still unclear if repairs will be necessary, the increase in crack spreads is warranted under the current conditions. Spared refineries could re-start in a week or two (if workers can access the facilities), but any damage could delay that timeframe by one or two months.

3- The Houston metro area population is close to 6.5 million, which ranks 4th in size in the United States' hurricanes that hit major cities have a tendency to lower overall demand for oil products as the economic activity is in emergency mode and the timeframe for normalization can range from weeks to months depending on the severity of the storm.

For energy, the hurricane is a refining margin story



Source: Datastream
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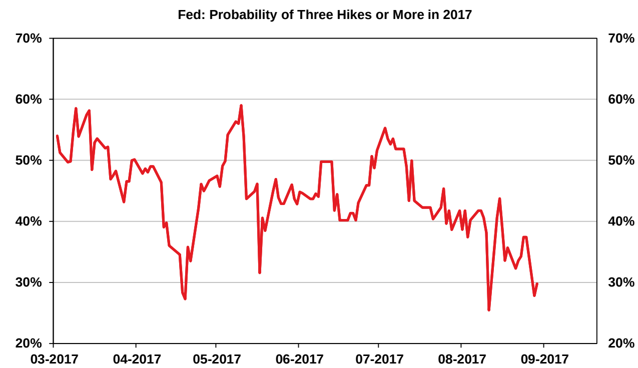
While we are still lacking clarity regarding the hurricane impact, we believe this event is bearish for crude on the short-term horizon. We expect fundamentals to slightly worsen in light of refinery shutdown and reduced demand for energy products as the area is recovering.

If the outages persist because of refining infrastructure damage, the supply and demand picture could materially worsen on the medium-term horizon and drag oil prices further down, despite gasoline prices shooting up.

Currencies: Swimming in Crosscurrents

As discussed in the Equities section, global growth is picking up, and such an environment is usually met with a weakening U.S. dollar, as foreign central banks have more incentives for monetary policy normalization. Meanwhile, domestically, the Fed is trying to calibrate its response to weak inflation figures, which are continuously reducing the market's expectations of a hike (Chart 8). Markets increasingly doubt the President will be able to enact any meaningful policies to encourage economic activity, which only adds to the impression that inflationary pressures will not pick up any time soon. The possibilities of a government shutdown and the potential impact on growth of Hurricane Harvey only add to the negative mood regarding the currency.

Increasing doubts that the Fed will hike again in 2017

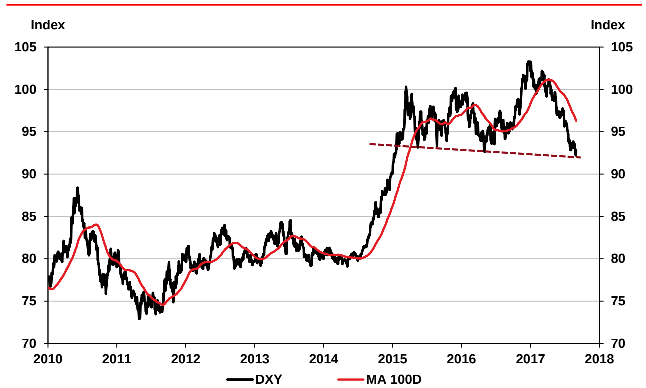


Source: Datastream
8

While it's undeniable the trend is pointing down for the greenback, some short-term forces could put a pause on the momentum. Technically, the DXY is rebounding on a support level (Chart 9). Speculative positioning, while still not at record levels, is now in short territory, a first since 2014 (Chart 10). These factors should not be ignored, as they could have a sizeable effect on the short-term performance of the currency and give the greenback a lift or at least mitigate some potential bearish news.

The reverse is true for the loonie. While growth is gaining momentum and our economic department still believes an interest rate hike is in the cards for October, speculative money is starting to tilt more and more on the long side (Chart 11). True, we could repeat the 2011-2013 scenario where positioning reached more extreme levels, but risks of a reversal are increasing. We also cannot ignore Harvey's impact on energy markets if refinery repairs create a crude oil downturn.

Will the support hold?



Source: Datastream
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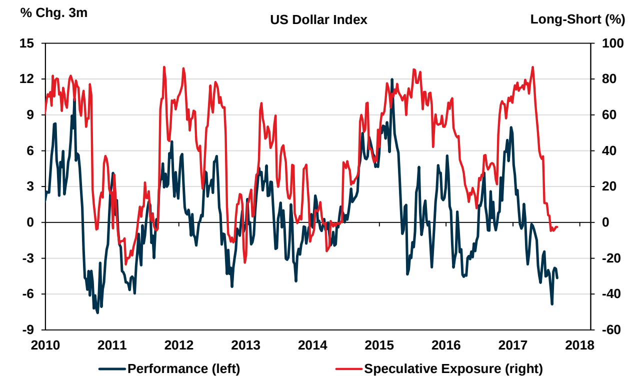
For the first time since 2014, the market is short USD



Source: Datastream
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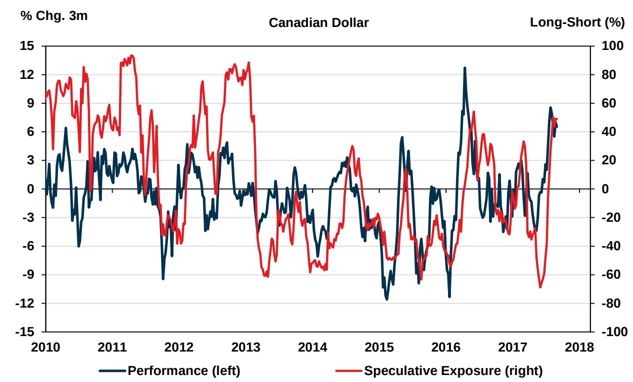
Risks of a reversal will increase as speculators add length



Source: Datastream
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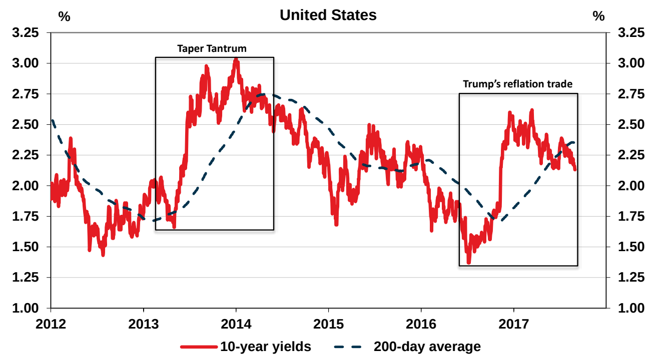
Consequently, we suggest a neutral position until we get more clarity regarding the Fed's intentions and the hurricane's impact on economic growth and crude oil demand.

Fixed Income: A Sense of Déjà Vu!

With barely any inflationary pressure in the system, geopolitical fears and lower market expectations for a fiscal package – whether in the form of infrastructure spending or tax reforms – have led U.S. 10-year bond yields to their weakest level of the year.

Although it would be easy to draw a parallel with the "taper tantrum" episode (Chart 12), and to expect bond yields to remain on a downward path, we think the situation is very different today. In 2013, the end of the Federal Reserve's (Fed) bond purchase program was rapidly offset by significant monetary policy accommodating measures from the European Central Bank (ECB) and the Bank of Japan. In contrast, the ECB has recently signaled its desire to gradually put an end to

U.S. 10-year bonds: A Sense of Déjà Vu?

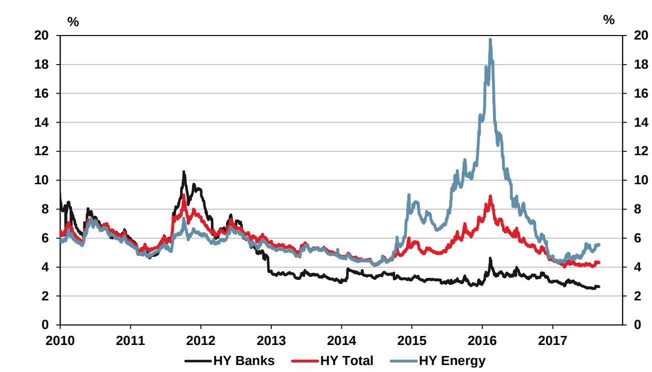


Source: Datastream
12

quantitative easing, perhaps as soon as September of this year. Additionally, economic growth is much more synchronous today, suggesting that other major central banks will join the Fed and the Bank of Canada in raising rates to alleviate pressure on currencies.

As such, we believe yields should re-test their long-term trend on the upside sometime before year end. However, with a potential for lower oil prices (see the Commodities section), we suggest keeping a neutral duration approach for the time being. In the eventuality of weaker crude prices, credit spreads could continue to deteriorate, but as in the 2014/2015 downturn, this should remain mostly concentrated in the energy sector (Chart 13).

Spreads to US treasuries



Source: Datastream
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