NATIONAL BANK

ASSET ALLOCATION STRATEGY

April 3, 2018

The backdrop is still good, but brace for volatility

Highlights

- Although we might be past peak growth for the world economy, history suggest that the level of activity remains high enough to generate decent equity returns.
- Credit spreads, which have always been good measures of equity market downturns, haven't deteriorated much since the beginning of the year suggesting the uncertainty created by tariffs and tech woes will not offset the global expansion.
- The U.S. Treasury yield curve has narrowed down lately due to a rally in back-end maturities, however it is still a ways from a recession signal. And, the projected path of interest rate hikes from the Federal Reserve suggest monetary policy is not going to get restrictive in the near future.
- In that context, we believe the outlook remains conducive of further gains in equities, and we will keep our overweight stock vs. bonds intact for a while longer.
- However, we reshuffled our geographical allocation, taking profits on our U.S. equity position and adding to Canadian and emerging markets (EM) stocks.
- Why reduce U.S. equities? The ever-rising risk of losing faith in the U.S. administration surely weighed in the balance, but signs of a rotation out of technology stocks, and the end of the tax reform "boost" in expected earnings, resulted in more downside risks south of the border.
- On the NAFTA negotiation front, new U.S. concessions in the auto industry are dramatically increasing the probability of an agreement before President Trump's May 1 deadline. Such an outcome would remove a huge thorn in Canada's side and give the Bank of Canada a clear path for a hike in May, which would lead to a narrowing of the gap between U.S. and Canadian rates and help the Loonie appreciate.
- As such, the case for rotating into CAD-denominated, cheaper, heavily-lagging and value-oriented Canadian stocks increasingly makes sense.
- We mitigate the sector allocation risks of our underweight in tech-heavy U.S. equities with an overweight in tech-heavy emerging markets where the growth outlook is better.

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)		■	▒		
MSCI EAFE (USD)			■		
MSCI EM (USD)			▒	■	
Factors and Alternative Investments					
Value vs. Growth			■		
Small vs. Large			■		
Low Vol. vs. High Beta		■			
Canadian dollar			▒	■	
Commodities				■	
Energy				■	
Base Metals				■	
Gold			■		
Infrastructure			■		

Source: CIO Office

Current Allocation ■

Previous Allocation ▒

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Market Review

Fixed income

- Demand for haven assets pressured down the yield on U.S. 10-year treasuries in March, while the first rate hike by the Federal Reserve in 2018 drove the shorter part of the curve higher.
- Canadian 10-year rates also declined, finishing the month at the lower bound of a tight trading range, much like its U.S. counterpart.
- Of note, the Bank of Canada kept its policy rate unchanged, awaiting clarification on the effects of previous hikes and NAFTA.

Canadian equities

- It was a rocky period for the S&P/TSX that got caught in a global risk-off movement and extended year-to-date losses.
- Yet, on a relative basis, Canadian equities did better than their U.S. alternatives, as the heavy weighted energy sector benefitted from rising crude prices.

U.S. equities

- The S&P 500 faced a “perfect storm” from trade war fears, White House departures and the tech stocks rout.
- Market jitters resulted in U.S. equities more than erasing their year-to-date gains, thereby posting their first quarterly loss since Q3-2015.
- Despite the pressure, technology and consumer discretionaries (which includes Amazon) are the sole sectors posting positive returns so far in 2018.

Commodities

- WTI crude oil prices have increased over 6% in March, supported by heightened geopolitical tensions and signs that supply curbs might last longer than expected.

Foreign exchange

- The Loonie started March on its heel, after the U.S. threatened to impose tariffs on imports of steel and aluminium, and Governor Poloz suggested that the pace of rate hikes might slow down.
- However, the Canadian dollar reversed course later in the month, with NAFTA optimism and accelerating inflation bringing the currency pair back to end-of-February levels.
- Despite all the turmoil in risk assets, the U.S. dollar finished the month slightly negative.

Table 2 **Market Returns**

Asset classes	March	Q1	2017
Cash (3-month T-bills)	0.1%	0.3%	0.6%
Bonds (FTSE/TMX Ovr. Univ.)	**0.8%**	**0.1%**	**2.5%**
FTSE/TMX Short term	0.2%	0.2%	0.1%
FTSE/TMX Mid term	0.7%	0.0%	1.0%
FTSE/TMX Long term	1.7%	0.0%	7.0%
FTSE/TMX Government	0.9%	0.0%	2.2%
Federal	0.7%	0.3%	0.1%
Provinces	1.0%	-0.3%	4.3%
Municipales	0.9%	0.0%	4.7%
FTSE/TMX Corporate	0.5%	0.3%	3.4%
AA+	0.3%	0.2%	0.7%
A	0.6%	0.2%	4.4%
BBB	0.5%	0.4%	4.0%
BoAML High-Yield (USD)	-0.6%	-0.9%	7.5%
Preferred shares	-0.7%	-0.1%	13.6%
Canadian Equities (S&P/TSX)	**-0.2%**	**-4.5%**	**9.1%**
Energy	1.9%	-9.4%	-7.0%
Industrials	-2.1%	-2.6%	19.7%
Financials	-1.1%	-3.5%	13.3%
Materials	0.3%	-4.3%	7.7%
Utilities	1.9%	-5.9%	10.8%
Cons. Disc	0.7%	-2.9%	22.8%
Cons. Staples	-1.5%	-5.9%	7.8%
Healthcare	0.3%	-13.5%	34.2%
IT	-1.2%	10.2%	16.8%
Telecom	-0.1%	-6.7%	14.8%
REITs	2.1%	0.5%	11.2%
S&P/TSX Small cap	-1.2%	-7.7%	2.8%
US Equities (S&P500 USD)	**-2.5%**	**-0.8%**	**21.8%**
Energy	1.7%	-5.9%	-1.0%
Industrials	-2.7%	-1.6%	21.0%
Financials	-4.3%	-1.0%	22.2%
Materials	-4.2%	-5.5%	23.8%
Utilities	3.8%	-3.3%	12.1%
Cons. Disc	-2.3%	3.1%	23.0%
Cons. Staples	-0.9%	-7.1%	13.5%
Healthcare	-3.1%	-1.2%	22.1%
IT	-3.9%	3.5%	38.8%
Telecom	-1.0%	-7.5%	-1.3%
REITs	3.8%	-5.0%	10.8%
Russell 2000 (USD)	1.1%	-0.4%	13.1%
World eq. (MSCI ACWI)	**-2.1%**	**-0.8%**	**24.6%**
MSCI EAFE (USD)	-1.7%	-1.4%	25.6%
MSCI EM (USD)	-1.8%	1.5%	37.8%
Commodities (CRB index)	**-1.5%**	**1.0%**	**2.2%**
WTI oil (US$/barrel)	5.6%	7.3%	12.5%
Gold (US$/ounce)	0.3%	1.5%	12.6%
Copper (US$/tonne)	-3.1%	-7.3%	30.5%
Forex (DXY - US Dollar index)	**-0.5%**	**-2.1%**	**-9.9%**
USD per EUR	0.8%	2.4%	13.8%
CAD per USD	0.5%	2.5%	-6.4%

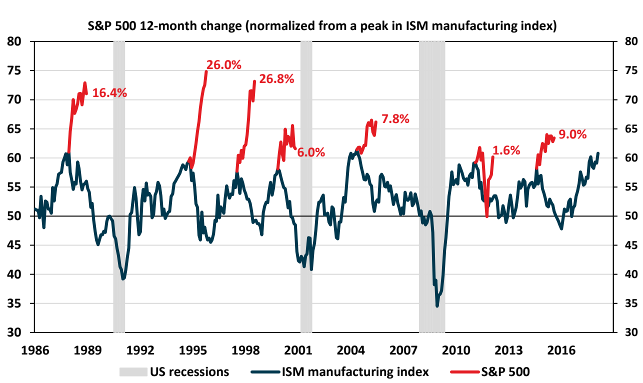
Source: Datastream 2018-03-30

Are we past peak growth?

Things were looking rather good for risk assets in early March, but a series of unfortunate events disrupted the uptrend. Some were unforeseen (like the Facebook data breach inquiry), some were ill-advised (like the U.S. tariffs threats) and some were just Hollywoodesque (like Trump's cabinet members being replaced almost at a daily pace). The first event is the most important in that it might give rise to regulatory changes and more oversight of the tech giants. But, it shouldn't be enough to prevent other sectors from taking over the leadership as we move toward the later stage of the cycle. The second event needs to be monitored closely. But, the risk of an outright trade war has been greatly exaggerated as both parties know that it is in their best interests to come to an agreement. The third event has to be considered for what it is: just plain noise, and very secondary to monetary and fiscal stimulus. So, why all the fuss? Is there more than meets the eye behind the recent market action? Are investors questioning the strength of the synchronous global expansion?

When we look at different U.S. and global data series, some certainly look toppish, but there is no indication that the music is about to stop. For example, take the ISM Manufacturing Index which fell to 59.3 in March after reaching 60.8 in February, a level only surpassed once before in the last 31 years. Clearly, with the Federal Reserve removing some policy accommodation and the marginal impact of the fiscal reform now behind us, it seems it will be very difficult for the Index to attain new highs. However, history shows that it doesn't really matter if we're past peak performance. For one, from these very high levels of economic activity it takes about two years on average before growth becomes negative. For another, despite the ongoing slowdown, the subsequent stock market 12-month performance has always been positive, with an average gain of 13% (**chart 1**).

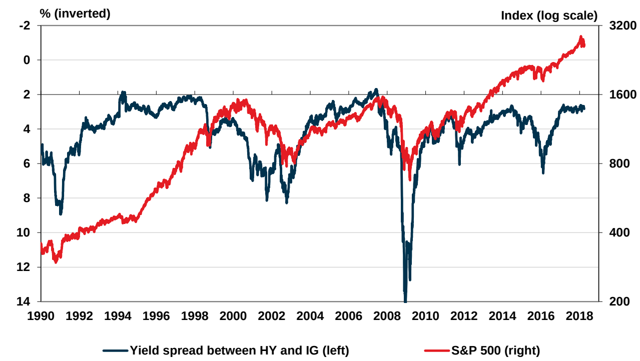
1 Plenty of growth to generate decent returns



Source: Datastream

Other indicators, such as credit spreads which have always been good measures of equity market downturns, haven't deteriorated much since the beginning of the year (**chart 2**). This suggests the uncertainty created by tariffs and tech woes will not offset the global expansion nor tip the world into recession.

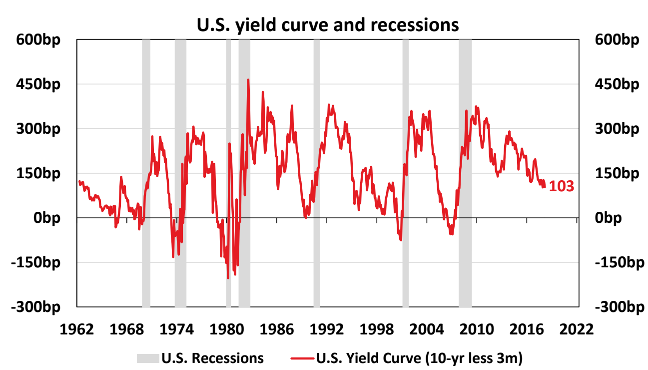
2 No deterioration in credit conditions



Source: Datastream

To be sure, we look at the slope of the U.S. Treasury yield curve – our favourite measure of recession probability (**chart 3**). After steepening somewhat in January as inflation expectations were reassessed, the curve has narrowed down more lately due to a rally in back-end maturities. However, at more than 100 basis points, the spread between U.S. 3-month T-bills and 10-year notes is still a ways from a recession signal. And, the projected path of interest rate hikes from the Federal Reserve suggest monetary policy is not going to get restrictive in the near future.

3 No recession in sight



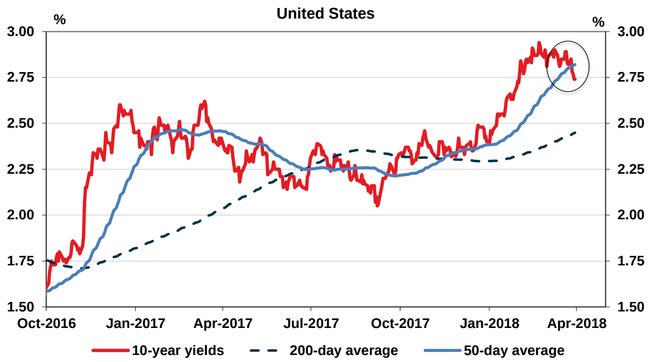
Source: Datastream

In that context, we believe the outlook remains conducive of further gains in equities, and we will keep our overweight stock vs. bonds intact for a while longer (see the Equities section for more details on our global positioning).

Fixed Income: Stuck between a rock and a hard place

Fixed-income securities managed good performance in March, especially at the longer-end of the curve. Due to a mix of technicals, low inflation, a dovish Fed, political gyrations and a pullback in risk assets, yields on U.S. 10-year notes broke their upward trend for the first time this year after testing the 2.9% resistance (**chart 4)**.

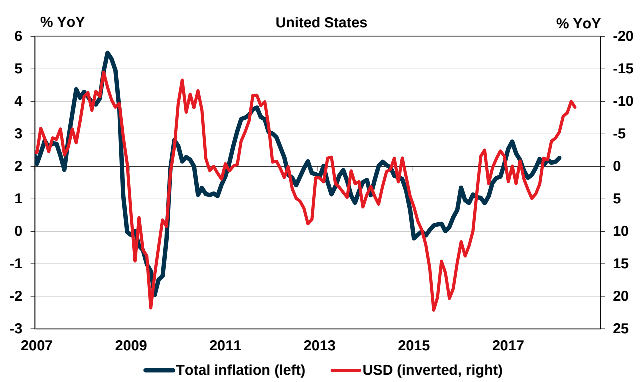
4 U.S. bond yields: Temporary softness…



Source: Datastream

We think it is only a temporary outcome. For one, the general market tone was strikingly negative in March. But, safe havens such as government bonds should give back some of their monthly gains if risk assets rebound as we expect. For another, inflation remains stubbornly well-behaved. However, it is only a matter of time before it accelerates, reflecting the past few years' acceleration in economic growth, the depreciation of the U.S. dollar (**chart 5)**, and the tightness of the labour market.

5 … as inflation should slowly increase

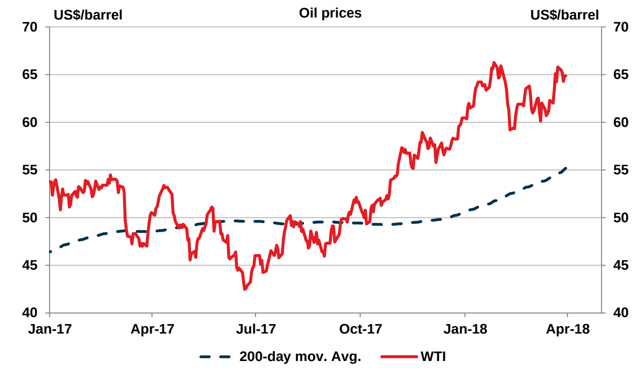


Source: Datastream

Commodities: U.S. is flexing its exporting muscle

Crude oil prices seem to have been somewhat isolated from the equity market turmoil witnessed in recent months. At first glance, the 10% drop in February seems steep, but one must be aware that commodity markets are inherently more volatile. For example, we witnessed three corrections for crude in 2017. So, the recent downturn from $65 to $59 followed by a rebound back to $65 is par for the course (**chart 6**).

6 Oil prices doing well on a relative basis

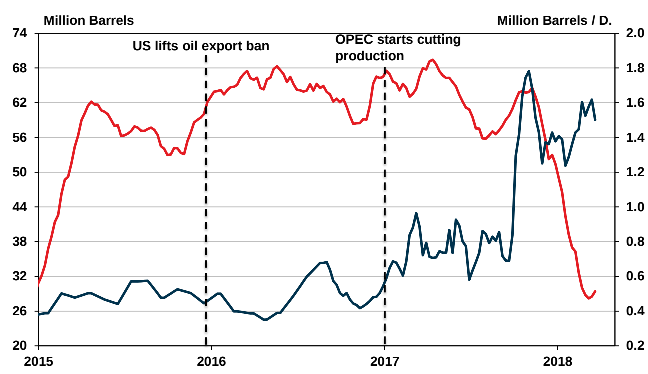


Source: Datastream

The reason for such "calm" can be found in the equilibrium established since the OPEC deal. True, synchronized global growth has increased demand projections, and the cuts from the cartel have put a dent in world inventories. But U.S. shale oil is picking up the slack, and the country is emerging as an exporter filling the vacuum left by reduced OPEC output.

This development has been about 2 years in the making, as December 2015 marked the date the U.S. decided to reverse the 1975 oil export ban, which originally aimed to reduce the country's reliance on foreign oil. The 2014 supply glut forced the government's hand in supporting its energy sector's growth by finally opening up the world market to domestic producers to solve the ever-increasing inventories. The fact that exports started materially picking up in Q1-2017 is no surprise as it coincides with the enactment of the OPEC cuts (**chart 7**). Consequently, as long as OPEC maintains relatively stable its total output, and global growth continues on the actual trend, we expect prices to slowly appreciate.

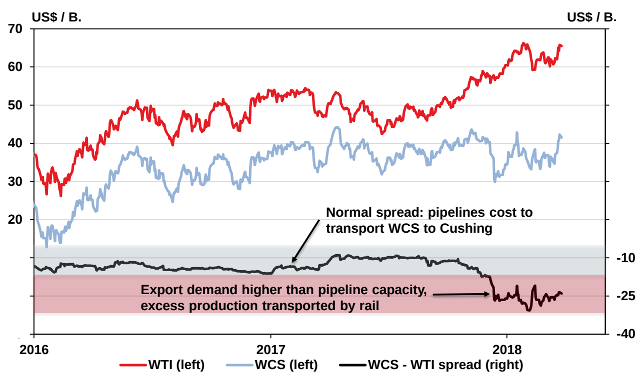
7 US exports are the main driver in Cushing draws…



Source: Datastream

What does this mean for Canadian companies and Western Canadian Select (WCS)? In light of no material development in Canada's export capabilities, the WCS–WTI spread has remained within a range incentivizing transport by rail (**chart 8**). Consequently, we expect any further appreciation in WTI would translate directly to WCS outright prices, especially in light of Cushing inventories continuously drawing. For Canadian producers, we think the current WCS prices are close to levels at which the companies can cover operating costs and still offer dividends, but more upside would be welcome.

8 … will it finally translate to WCS appreciation?

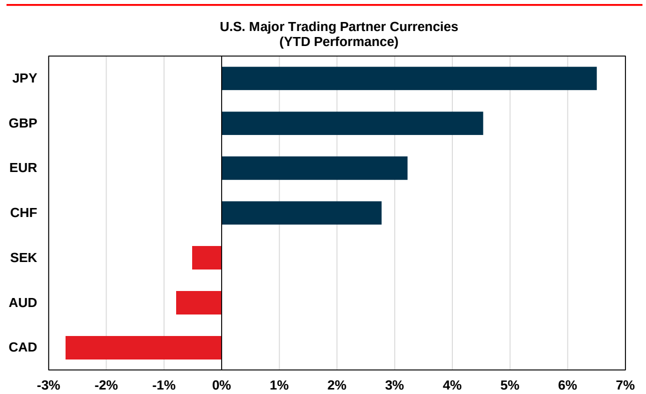


Source: Datastream

Currencies: Light at the end of the tunnel for the Loonie

Since the U.S. election, Canada has had to suffer the slings and arrows of outrageous fortunes regarding its southern neighbour and trade deals. No wonder the Loonie has suffered compared to other currencies in recent months (**chart 9**).

9 Foreign uneasiness about the Loonie is dragging it down

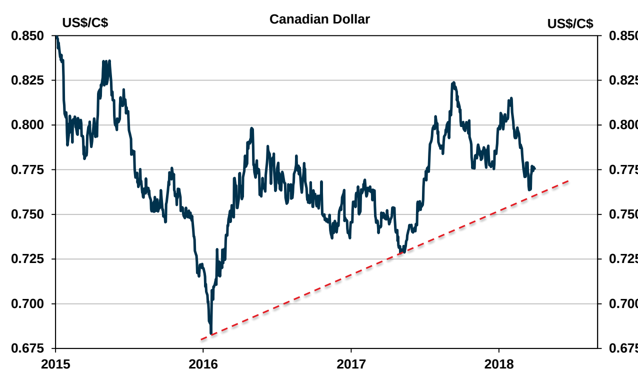


Source: Datastream

In fact, trade and political turmoil south of the border is not the only factor to consider in the currency's underperformance. The country's perceived risks regarding its domestic real estate market and high household debt are concerns abroad. The over-reliance on the energy sector (economically and as a big weight in the S&P/TSX) is also not helping in drawing foreign capital, especially when production is subject to operational exporting constraints. Despite any opinion Canadian financial professionals or analysts may have on the matter, in a market where synchronized global growth is in full swing, Canada is not an attractive destination for investors, especially when they have the luxury of investing in countries where such concerns are less of an issue.

However this presents us with an opportunity as the winds are changing. On the NAFTA negotiation front, new U.S. concessions in the auto industry are dramatically increasing the probability of a NAFTA agreement before President Trump's May 1 deadline. Such an outcome would remove a huge thorn in Canada's side and give the Bank of Canada a clear path for a hike in May, which would lead to a narrowing of the gap between U.S. and Canadian rates and help the Loonie appreciate. An agreement could also spur some corporate investments in the country as the fear of being on the wrong side of the tariff barrier would dissipate. In conclusion, we think most of the negative influences have been priced-in for the Loonie, and a floor at 77 cents is forming (**chart 10**) which signals that Canadian dollar weakness is probably behind us.

10 Bad news priced in = upside potential for the loonie



Source: Datastream

Equities: Buckling up for a roller-coaster year

Equities resilience was tested once again in March, with the S&P 500 taking another roller-coaster ride all the way down to its 200-day moving average (**chart 11** next page).

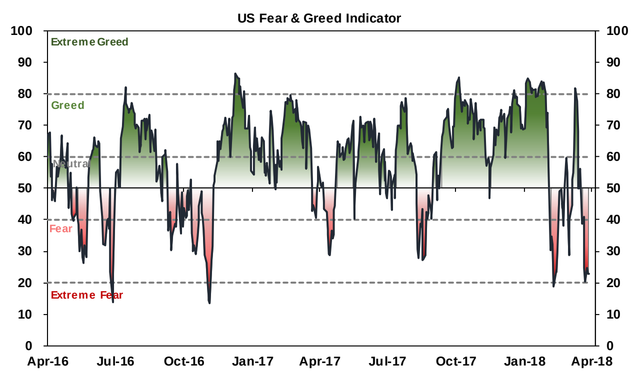
There was no shortage of reasons for risk aversion to rise. For instance, March began with President Trump tweeting that "trade wars are good, and easy to win," after unveiling tariffs on imports of steel and aluminum. Thereafter, Gary Cohn, the Director of the White House National Economic Council resigned, Secretary of State Rex Tillerson was fired, and White House National Security Adviser Lt. Gen. H.R. McMaster was ousted to be replaced by John Bolton, a foreign policy "hawk." Topping things off, the U.S. administration announced plans to

11 The S&P 500 went for another roller-coaster ride…

Source: Datastream

impose tariffs on up to $60B of Chinese imports to which China countered with potential tariffs on around $3B of U.S. imports. The combination of trade war fears and a 'new-by-the-day' U.S. administration inevitably ended up spooking the equity market (**chart 12**).

12 …spooked by trade war fears and White House reshuffle



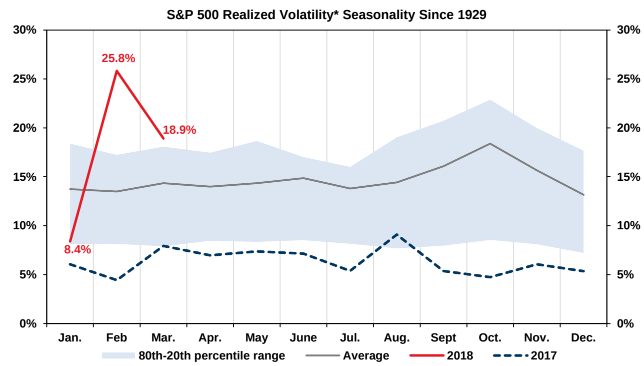
Source: Datastream

Volatility comeback was to be expected following the record-breaking calmness of 2017. But, not only is it back, it literally went from one extreme to the other (**chart 13**).

On the flip side, the earnings backdrop remains just as sound as it was in 2017. As such, if valuation multiples would have stayed where they were in December, all major indices would be well in positive territory after Q1. Rather, PE compression has more than offset the increase in earnings in most cases, resulting in somewhat disappointing returns YTD (**chart 14**).

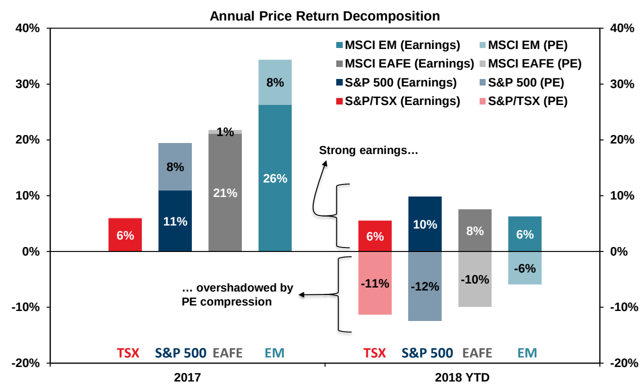
Admittedly, valuations (especially in the U.S.) were due for a mean reversion, and the recent surge in risk aversion was the trigger needed for it to happen (**chart 15**).

13 Volatility: from one extreme to the other



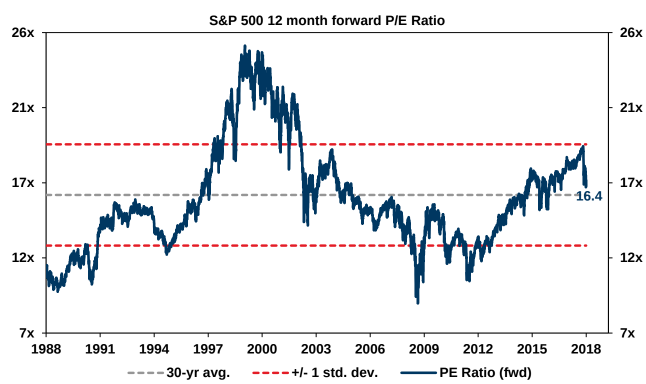
Source: Datastream

14 Strong earnings overshadowed by PE compression



Source: Datastream, as of March 28th

15 Valuations were due for a mean reversion



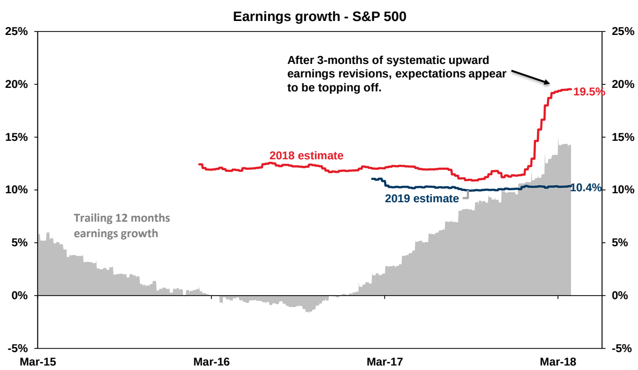
Source: Datastream

At those levels and an economic backdrop still prone to risk assets outperformance, we continue to favour equities over safer alternatives. However, we reshuffled our geographical allocation on March 21, taking profits on our U.S. equity position and adding to Canadian and emerging markets (EM) stocks.

Why reduce U.S. equities? The ever-rising risk of losing faith in the U.S. administration surely weighed in the balance, but signs of a rotation out of technology stocks, accelerated by the revelation of political consultancy Cambridge Analytica's use of Facebook data settled the case.

Also of importance, the end of the tax reform "boost" in expected earnings, as illustrated by the projected growth for 2018 topping off lately at 19.5%, resulted in more downside risks south of the border, in our view (**chart 16**).

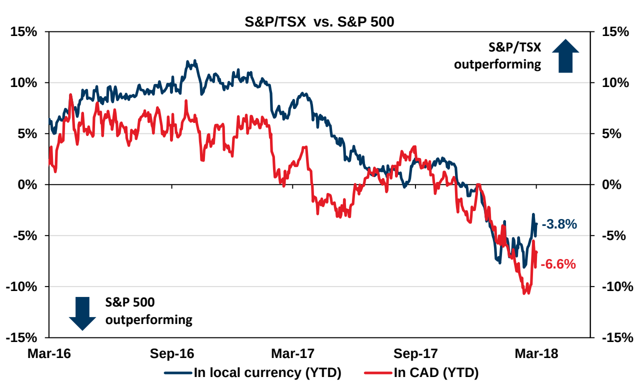
16 Tax reform fully priced-in → Increased downside



Source: Datastream

Therefore, with signs that NAFTA concerns might dissipate as early as this month (see Currencies section), the case for rotating into CAD-denominated, cheaper, heavily-lagging and value-oriented Canadian stocks increasingly makes sense (**chart 17**).

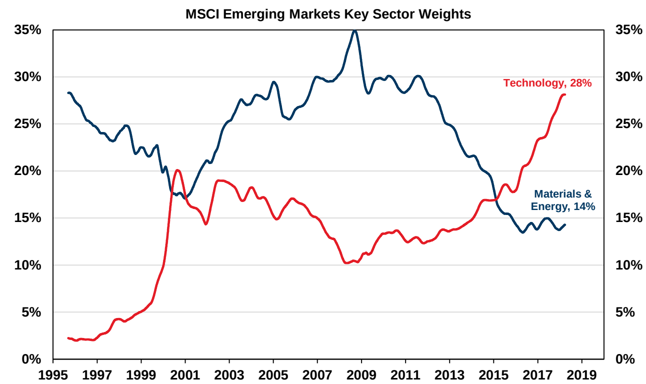
17 Canada: an increasingly attractive laggard



Source: Datastream as of March 27th

Notwithstanding regulatory worries overshadowing U.S. tech companies, it remains that the implied short position in technology arising from an S&P/TSX overweight has proven to be costly for many years now. That's where our EM overweight comes into play. Indeed, Canadian and EM equities are much more complementary nowadays – Commodities' share of EM has shrunk by over half over the last decade, while the outperforming Technology sector has nearly tripled in weight (**chart 18**). To put it simply, we mitigate the sector allocation risks of our underweight in tech-heavy U.S. equities with an overweight in tech-heavy emerging markets.

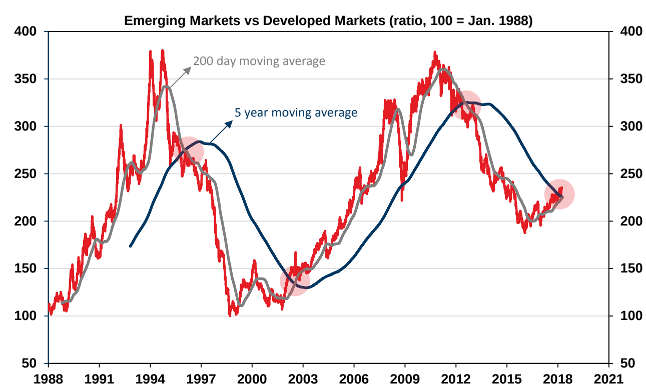
18 Commodities cut in half, technology tripled since 2008



Source: Datastream

There are also reasons to believe that the already two-year-old EM leadership will persist in 2018 and beyond (**chart 19**). Valuations continue to compare favourably, growth prospects are picking up momentum, macro factors are aligning, and all this without blatant excessiveness in EM sentiment. For more details, see our March 20 Strategic Report: *Grown-Up Emerging Markets*.

19 EM/DM cycles at a crossroads → More upside ahead



Source: Datastream

Over the next few weeks, trade negotiations will have to be monitored very closely, with the 30-day consultation period between the U.S. and China starting once the list of targeted goods is published, and the 8th round of NAFTA talks tentatively set for April 8 in Washington.

But one thing is certain, with (1) the tax reform fully priced-in and, by extension, no longer here to dampen noises, (2) the FED tightening, and (3) economic indicators already through the roof, investors should buckle up for a roller-coaster year.