NATIONAL BANK

ASSET ALLOCATION STRATEGY

December 3, 2018

Unfinished Business

Highlights

- After November got off to a strong start, global equity markets revisited their lows, with crude oil prices sinking to their lowest point since October of last year. Is this an indication of a global bear market in the making? We think not.
- Global economic fundamentals remain strong; the spike in high-yield spreads appears to be inflated by the energy sector, and is not an indication of widespread weakening credit quality. What's more, no matter how uncertain the future may be, the reality is that the 2018 equity ratio contraction is of an amplitude only seen during recessions… at a time when the world economy is growing. Opportunities like this rarely show up.
- We should be careful before calling this the end for high-growth technology securities. Now that they've sagged considerably, investors are likely to look to the deviation from an earnings-fueled long-term trend in technology stocks as an opportunity, provided that risk appetite returns, naturally. As for emerging markets, a single month of outperformance amid such volatility is not convincing enough to significantly change our model recommendation. Under these circumstances, we keep our geographical allocation unchanged.
- Fed Chair Powell made sure to allay investors' concerns over the central bank's rate hike path with his announcement that interest rates are "just below" what is deemed the neutral rate. In Canada, crude oil's weakness did nothing to simplify the conduct of monetary policy in a country with such divergent economic realities from coast to coast. Considering that the pressure for higher rates from central banks has diminished, the need for a short duration position in our portfolios is less important. We think it's time to start taking a more prudent approach towards duration risk as the cycle continues to age.
- The bear market in crude oil prices is the result of a supply problem combined with speculative selling, not decreased demand. Considering that most of the bad news is behind us, we believe the next quarters will see crude prices increasing, as they will benefit from OPEC support and a reversal of the temporary downside pressures we recently witnessed.
- For the loonie, as we said multiple times, the rate differential has much more influence on the value of the pair than energy prices, but the recent crude oil drop is large enough that it could affect monetary policy down the road and, consequently, the value of the Canadian dollar. Despite the current environment, we expect energy products to rebound in the coming months (including the WCS to WTI spread) and the currency should follow, especially given our opinion that the U.S. dollar will weaken.

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

- We saw mild gains for most fixed income benchmarks in November, as the appetite for safer assets and comments from Federal Reserve Chairman Powell pushed 10-year bond yields lower on both sides of the border.
- Credit spreads of high-yielding U.S. companies have widened slightly during this second consecutive month of high volatility for risky assets, resulting in a mild -0.9% monthly loss for the benchmark and a flat performance year-to-date.

Canadian Equities

- Canadian stocks see-sawed last month, finishing the period 1.4% higher, as gains from defensive sectors such as consumer staples, telecommunications and utilities made up for weak returns in the energy space.
- The healthcare sector continued to fall prey to the frenzy surrounding marijuana equities, closing markedly lower for a second consecutive month.

U.S. Equities

- The S&P 500 post-midterm election relief was short-lived, with the benchmark revisiting correction territory after a free fall in energy stocks and sustained selling of some of the big technology names.
- Nevertheless, U.S. equities recovered strongly towards the end of November, supported by Jerome Powell's comments, interpreted as signaling that the central bank would go easy with respect to raising interest rates.

Commodities

- Crude oil prolonged its free fall, now down 34% since early October, caught in a perfect storm of softer-than-expected impacts from U.S. sanctions on Iranian oil, rising U.S. supply, and heavy speculative reversals.

Foreign Exchange

- The U.S. dollar index marginally appreciated last month, reaching its highest level since June 2017 during the worst of the selloff in global equities, but backpedaled later in November following a dovish interpretation of remarks by the Federal Reserve's chairman.
- The loonie extended its year-to-date losses, now amounting to 5.7%, as it bore the brunt of a 13-month low in crude oil prices and reduced expectations for another Bank of Canada interest rate hike in January.

Table 2 Market Returns

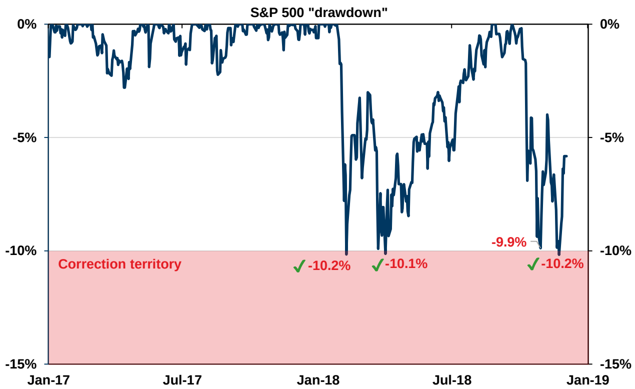
Asset classes	November	YTD	12 months
Cash (3-month T-bills)	0.2%	1.2%	1.2%
Bonds (FTSE/TMX Ovr. Univ.)	**1.0%**	**0.1%**	**-0.4%**
FTSE/TMX Short term	0.6%	1.0%	0.6%
FTSE/TMX Mid term	1.2%	0.3%	-0.6%
FTSE/TMX Long term	1.5%	-1.5%	-1.5%
FTSE/TMX Government	1.3%	0.1%	-0.4%
Federal	1.2%	0.7%	0.1%
Provincial	1.3%	-0.6%	-0.8%
Municipal	1.3%	-0.2%	-0.5%
FTSE/TMX Corporate	0.4%	0.0%	-0.3%
AA+	0.6%	1.0%	0.4%
A	0.6%	-0.7%	-1.1%
BBB	0.1%	0.0%	-0.4%
BoAML High-Yield (USD)	-0.9%	-0.1%	0.2%
Preferred Shares	-6.0%	-6.5%	-6.4%
Canadian Equities (S&P/TSX)	**1.4%**	**-3.7%**	**-2.5%**
Energy	-2.4%	-12.3%	-11.3%
Industrials	1.4%	7.5%	10.0%
Financials	1.9%	-2.4%	-1.7%
Materials	0.0%	-14.2%	-11.0%
Utilities	4.6%	-6.0%	-6.9%
Cons. Disc	2.9%	-8.2%	-8.7%
Cons. Staples	7.6%	3.1%	3.1%
Healthcare	-5.8%	0.8%	25.2%
IT	2.9%	19.1%	19.6%
Telecom	7.0%	2.0%	0.9%
REITs	0.6%	6.7%	7.7%
S&P/TSX Small Cap	-3.9%	-15.2%	-13.0%
US Equities (S&P500 USD)	**2.0%**	**5.1%**	**6.3%**
Energy	-1.6%	-6.2%	-1.6%
Industrials	3.8%	-2.9%	-1.1%
Financials	2.8%	-2.0%	-0.1%
Materials	4.0%	-8.4%	-6.6%
Utilities	3.6%	8.5%	1.8%
Cons. Disc	2.8%	10.0%	12.7%
Cons. Staples	1.9%	0.8%	3.0%
Healthcare	7.1%	16.5%	15.8%
IT	-1.9%	8.9%	8.9%
Telecom	-0.7%	-5.7%	-0.2%
REITs	5.6%	5.6%	5.1%
Russell 2000 (USD)	1.4%	-0.1%	-0.7%
World eq. (MSCI ACWI)	**1.5%**	**-2.1%**	**-0.5%**
MSCI EAFE (USD)	-0.1%	-9.0%	-7.5%
MSCI EM (USD)	4.1%	-12.0%	-8.8%
Commodities (CRB index)	**0.1%**	**-3.8%**	**-3.2%**
WTI Oil (US$/barrel)	-22.2%	-16.0%	-11.5%
Gold (US$/ounce)	0.3%	-6.5%	-4.7%
Copper (US$/tonne)	3.2%	-13.6%	-7.5%
Forex (DXY - US Dollar index)	**0.1%**	**5.6%**	**4.5%**
USD per EUR	-0.1%	-5.7%	-5.0%
CAD per USD	1.1%	5.7%	3.1%

Source: Datastream 11/30/2018

Unfinished Business

After November got off to a strong start, global equity markets revisited their lows, with the S&P 500 making sure that it ticked the "correction" box, for a third time this year (**chart 1**).

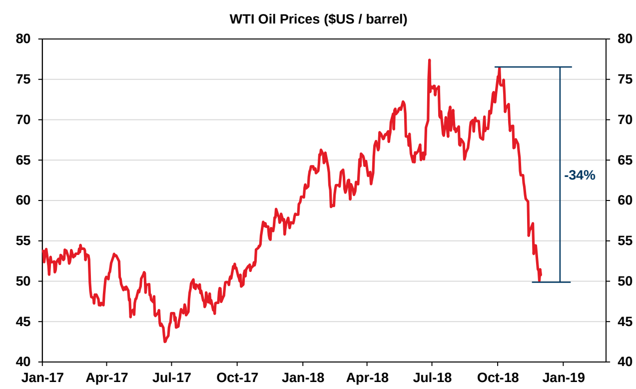
1 A third stock market correction this year…



Source: Datastream

We also witnessed crude oil prices sink to their lowest point since October of last year, wiping out what was referred to as the "trade of the year" in a matter of just a few weeks (**chart 2**, more details in Commodities section).

2 ... and a sharp drop in oil prices of bad omen?

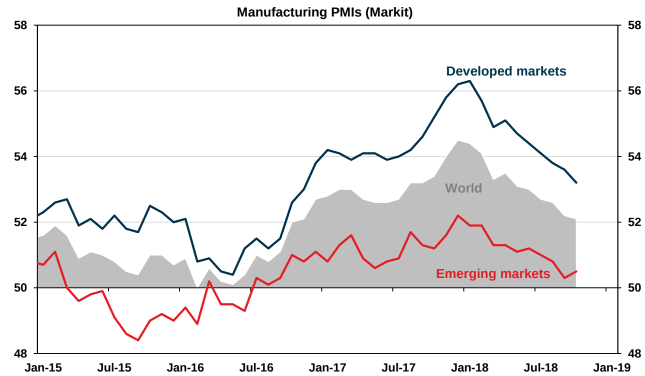


Source: Datastream

At this point, it comes down to whether the persistence of volatility after a red October and tumbling energy prices are an indication of a global bear market in the making, or if these movements – as we've argued in last month's publication – are simply overdone.

Economic fundamentals have not significantly changed in the meantime. The U.S. labour market is still in record shape (latest job report showed a solid +250k new jobs and the fastest wage growth in nearly a decade at 3.1% YoY), and consumer confidence remains near all-time highs. True, global manufacturing activity is undoubtedly losing momentum, but it is down from record levels and still well-entrenched in growth territory (**chart 3**). Nothing new here.

3 Global economy: slower but still growing

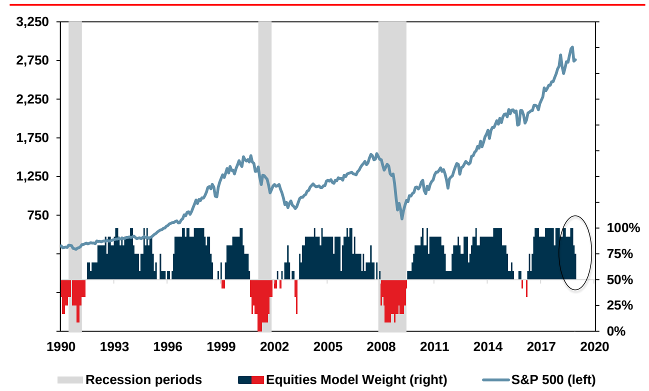


Source: Datastream

Another factor of stress has been the Federal Reserve, which is widely expected to increase its benchmark rate on December 19, for a fourth time this year and ninth in this cycle. More specifically, global markets had clearly not digested Jerome Powell's October comments about the central bank being "a long way" from getting rates to neutral. Thankfully for risk assets, the Fed Chairman readjusted his message at the Economic Club of New York on November 28, this time characterizing rates as "just below" estimates of neutral. We therefore hold on to our view that gradual monetary policy tightening will carry on next year, but not at a pace that would prevent risk assets from outperforming.

Nevertheless, it is worth noting that our A3 model – whose goal is to translate the investment backdrop into a risk-on/risk-off recommendation – has recently reduced its risk appetite, in the face of rising credit spreads (**chart 4**).

4 A3 model: a slightly lower risk appetite



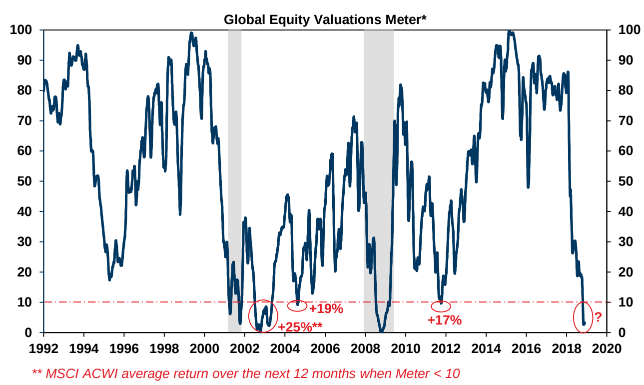
Source: Datastream

However, much as we chose to deviate from its maximum stock overweight recommendation earlier this year given Trump's unpredictable trade brinkmanship and late-cycle signals, we decided to stick to our stock overweight, mainly for the two following reasons.

First, the spike in U.S. high yield credit spreads is far from disproportionate given the level of volatility witnessed in the equity market. It also appears to be inflated by the energy sector, not an indication of widespread weakening credit quality that typically precedes recessions (see the Fixed Income section for more details).

Secondly, and perhaps most importantly, no matter how uncertain the future may be, the reality is that 2018 ratio contraction is of an amplitude only seen during recessions… at a time when the world economy is showing strong growth. Opportunities like this rarely show up, and the few episodes of our global valuations meter being this low outside of a recession were followed by significant returns for risk assets (**chart 5**).

5 2018 P/E ratio contraction is almost unprecedented



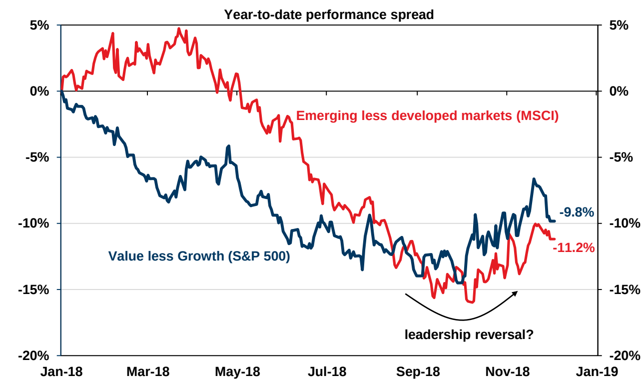
Source: Datastream. *Global equity valuations meter = Average of S&P 500, MSCI EM, MSCI EAFE and S&P/TSX 12-month forward PE Ratio percentile ranking over a rolling 5-year window.

Markets breathed a sigh of relief in the days leading up to the US-China face-to-face at the G-20 summit in Argentina, anticipating accurately that tensions between the two super powers were likely to ease. This is obviously good news, but we should not be under any illusion that this conflict is over. There is still a lot of wood to chop before the constant threat of an acceleration of the US-China trade spat fades into history, and this uncertainty is likely to keep driving volatility in global equities. In any case, corporate and economic fundamentals lead us to conclude that we are not yet finished with this bull market.

Equities: Leadership Reversal?

The turbulence of the last few weeks generated a certain reversal in some of the key 2018 stories, namely growth/tech dominance and emerging markets underperformance (**chart 6**).

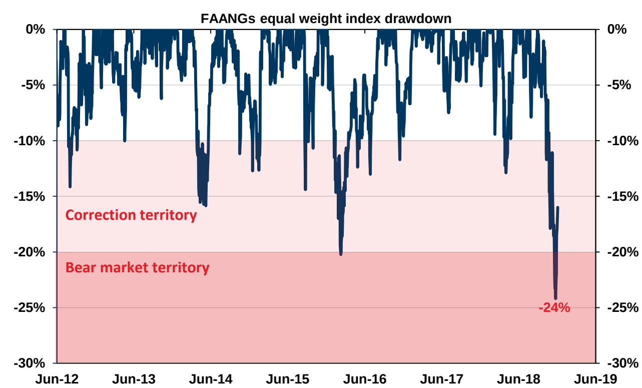
6 Reversal in some of the key 2018 stories



Source: Datastream

Indeed, we've seen October's pull-back of the all-mighty U.S. tech giants evolve into a severe correction in November, with an equally-weighted index of the FAANGs (Facebook, Apple, Amazon, Netflix, Alphabet/Google) dropping 24% from its August 30 peak (**chart 7**).

7 Most severe correction of the short FAANGs' history …



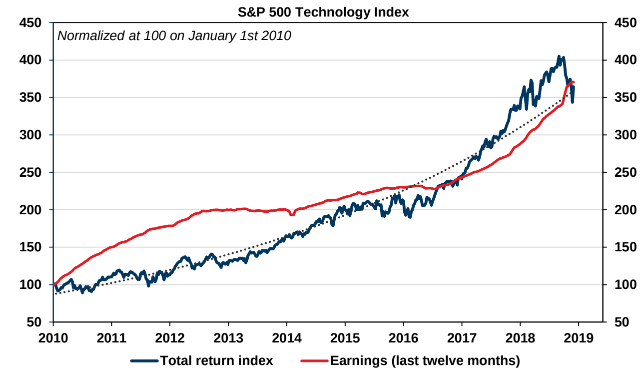
Source: Datastream

We should be careful before calling this the end for high-growth technology securities. Much like any top of their class, FAANGs had a target on their back and were the most likely victim of profit-taking as 2018 drew to a close. Now that they've sagged considerably, investors are likely to look to the deviation from an earnings-fueled long-term trend in technology stocks as an opportunity, provided that risk appetite returns for good, naturally (**chart 8**, next page).

Emerging markets' (EM) sharp outperformance in November is another story (**chart 9**, next page).

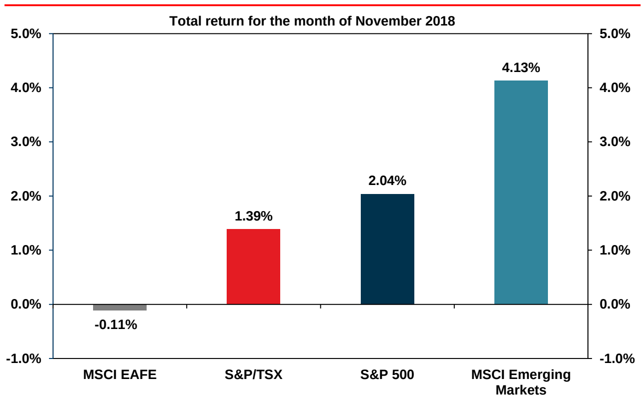
Our avid readers will recall that last March, we published a report making the case for better long-term return prospects in EM, which we initially supported by a tactical overweight. Faced with an accelerating trade war scenario, we chose to revert to neutral in June, finding refuge in North American stocks; a decision that (thankfully) more than made up for our terrible EM timing. Since then, we have made it clear that we were waiting for (1) a clear reversal signal from our relative momentum

8 ...but they probably haven't said their last word



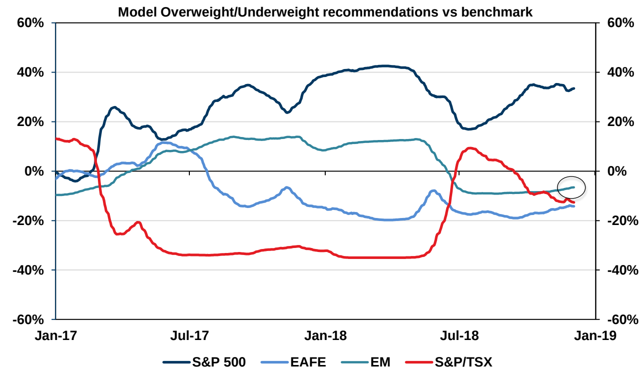
Source: Datastream

9 Sharp emerging markets outperformance in November...



Source: Datastream

10 ... but too volatile to really change our model's status



Source: Datastream
Benchmark = 35% S&P 500, 35% S&P/TSX, 20% MSCI EAFE, 10% MSCI EM

model and (2) clarity on trade before increasing to our emerging markets position.

One of the virtues of having a model like ours is that it prevents overreaction from what can sometimes feel like a massive game-changer that ends up being just a temporary blip. Only time will tell in which category November's EM advance will end up, but a single month of outperformance amid such volatility is not convincing enough to significantly change our model recommendation and be characterized as a clear reversal signal (**chart 10**).

As for the fog associated with a trade war, no matter how nice and smoothly President Trump's heart-to-heart with Chinese President Xi Jinping unfolded at the G20, the truth is the conflict remains far from being clearer.

Indeed, we learned over the weekend that the U.S. has opted to postpone by 90 days the increase in tariffs on over $200 billion worth of Chinese imports, which were initially expected to rise from 10% to 25% in January. In return, China apparently agreed to purchase "a not yet agreed upon, but very substantial" amount of farm, energy and industrial goods, according to the White House. It can, therefore, be assumed that the two countries are about to deal head-on with the much contentious issues of alleged forced technology transfers, intellectual property theft and cyber-crime over the coming months. Given Trump's approach, this is likely to come with surprises and, consequently, volatility for risk assets.

Under these circumstances, we maintain our geographical allocation (neutral S&P/TSX and Emerging Markets, overweight S&P 500, and underweight EAFE) for a third consecutive month.

Fixed Income: Moving Parts

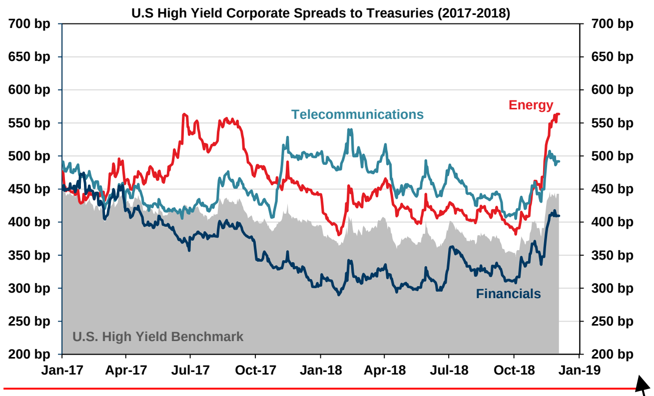
As mentioned in the introduction, investors' recent reluctance for risk-taking started to be felt in the high-yield space, with credit spreads reaching their highest level since April of last year, thereby pushing our A3 model closer to a neutral stance. This is a situation that warrants close monitoring in the weeks to come. However, we think it would be premature to raise a red flag based only on this signal.

For instance, although financial and telecommunications companies have also seen their cost-of-debt rising, the move in the benchmark is undoubtedly inflated by the steep surge in the credit spread of high-yielding U.S. energy companies that ensued from falling crude oil prices (**chart 11**, next page).

Above all, if we zoom out from the last two years, the recent climb in credit spreads is far from indicative of a recession/crisis in the making (**chart 12**).

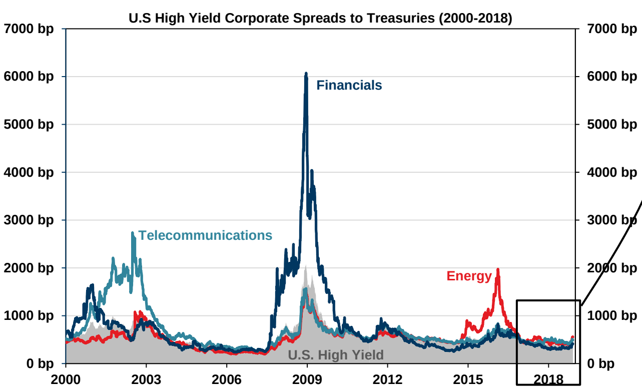
In addition, Fed Chair Powell made sure to allay investors' concerns over the central bank's rate hike path with his announcement that interest rates are "just below" what is deemed the neutral rate, which marks the level at which the monetary policy is neither restrictive nor accommodative.

11 The rise in credit spreads is not benign ...



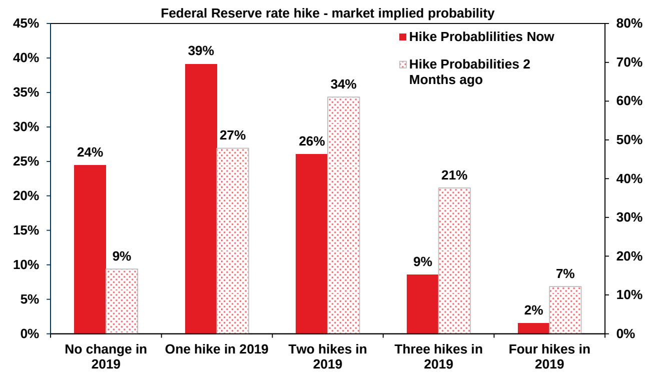
Source: Datastream

12 ... but remains far from alarming in hindsight



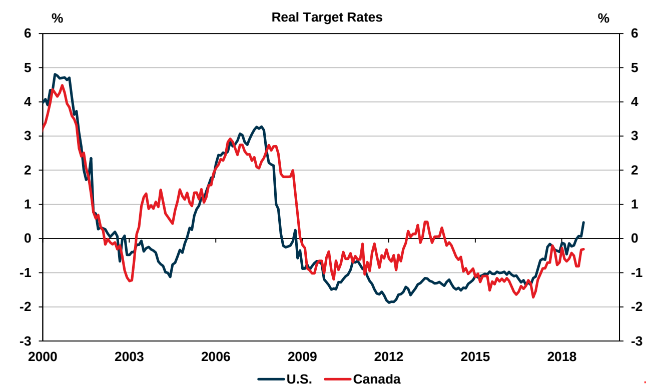
Source: Datastream

13 Markets are now expecting a much more dovish Fed



Source: Datastream

14 The BoC is lagging the Fed in real terms



Source: Datastream

In a way, the FOMC can afford to be patient, as the energy downturn and lower import prices due to a higher U.S. dollar should act as a drag on inflation numbers and somewhat mitigate the impact of rising wages. The core PCE down-ticking (from 2.00% year-over-year to 1.80%) in October is a good example showing that inflation is by no means accelerating beyond control for now. Consequently, market expectations regarding the number of hikes in 2019 have been significantly revised down (**chart 13**).

In Canada, crude oil's weakness did nothing to simplify the conduct of monetary policy in a country with such divergent economic realities from coast to coast. Mr. Poloz will have a tough balancing act to follow as central bank policies can take up to 18 months to take effect economically, which is an eternity in the commodity space. If we take into account that inflation numbers are close to the Bank of Canada's target and the jobless rate is hovering close to a decade-long record low, the puzzle becomes even more complex. Let's not forget that, contrary to its southern neighbor, Canada still has a negative real target rate (**chart 14**).

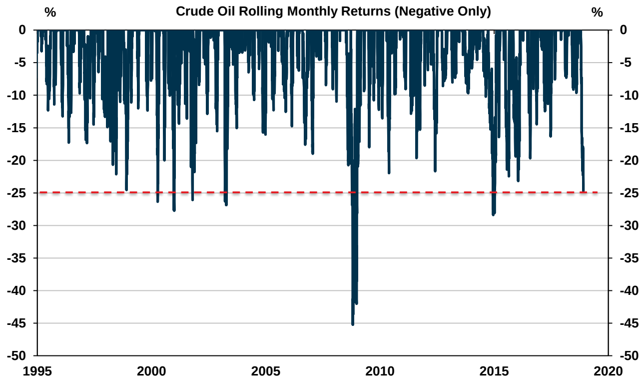
However, for now, it seems that Alberta's woes are winning the tug-of-war as a January hike is becoming less and less likely (60% market implied probabilities as of this writing). As the pressure for higher rates from central banks has diminished, the need for a short duration position in our portfolios is less important. By slowly neutralizing duration risk we can gradually increase the bond's effectiveness as a counterpoint to our equity overweight.

This doesn't mean that we are going into a full risk-off position, just that we think it's time to start taking a more prudent approach as the cycle continues to age.

Commodities: The Hangover

Only a couple of months ago, we were optimistic regarding crude oil's fortunes as supply sources remained at risk of disruption, demand growth was still robust and doubts were emerging over OPEC's capacity to fill the gap should supply decrease any further. After reaching a 4-year high early in October, oil prices started collapsing; what went wrong (**chart 15**, next page)? The answer is a combination of multiple factors which formed the perfect storm:

15 The energy correction was quick and severe



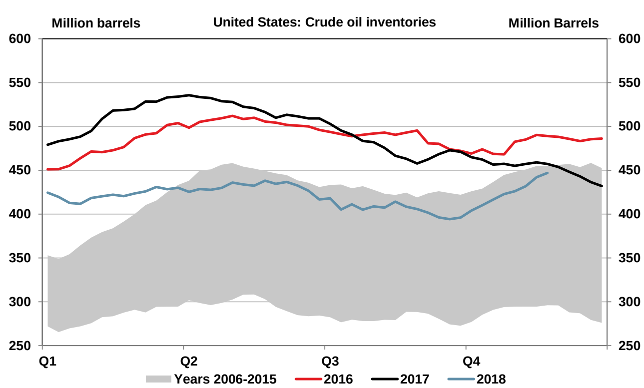
Source: Datastream

1. The first hit came from the White House reversing its initial plan regarding Iranian sanctions, granting a waiver to the country's eight major importers. This unexpectedly adds more than 1 million barrels per day (mbpd) to the supply picture.

   While some may interpret this as a softening of the U.S. administration's stance regarding Iran, the main objective of these waivers is to give some time to the country's allies to find new sources of supply. The waivers are still expected to expire in the coming quarters, so the respite should only be temporary in nature unless extensions are granted.

2. U.S. production continues to increase at a fast pace, pushing domestic inventories at a clip that is higher than seasonal norms (**chart 16**). The ramp-up in activity, which culminated with a record output of 11.7 million barrels per day in October (an increase of 2 mbpd year-over-year) only added to the downward price pressure as domestic producers took advantage of improved margins earlier this year.

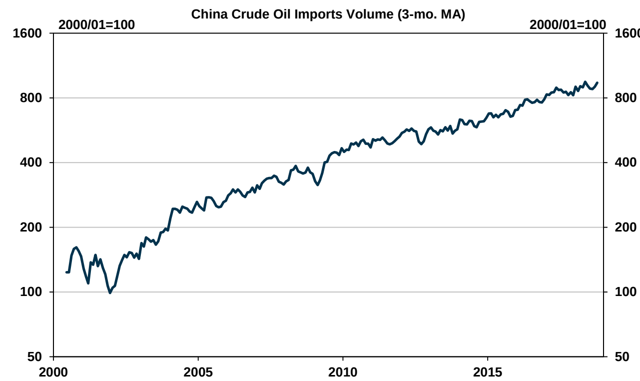
16 Inventories are growing faster than expected



Source: Datastream

3. The risk-off mindset permeating financial markets also impacted energy prices. Fears that emerging markets, especially China, are slowing down, which could potentially translate into decreased demand for crude down the road, only adds to the selling pressure. However, for now, this particular scenario has not materialized into lower import numbers from the Middle Kingdom (**chart 17**).

17 No sign of slowing down in Chinese crude oil imports



Source: Datastream

4. Volatility begets volatility, and commodity markets are especially vulnerable when prices drop over a very short timeframe. One of the reasons is the use of put options by companies to hedge their future production. As financial firms offer them the service of warehousing the risk, they expose themselves to downside volatility (the term for such a position is "short gamma").

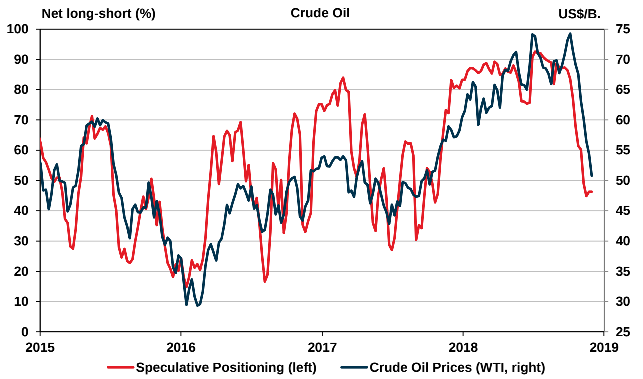
   This implies that the more violently prices drop, the more financial firms have to sell crude oil to hedge and mitigate their increasingly short exposure, thus compounding the effect and generating a vicious circle. Usually, this results in a market that becomes severely oversold and prone to sharp reversals.

5. In light of an unexpected shift in the supply-and-demand picture as well as the risk-off in world markets, speculators severely reduced their long positioning (**chart 18**, next page) thus amplifying even more the downside effect of all the factors enumerated above.

Consequently, this bear market is the result of a supply problem combined with speculative selling, not decreased demand. This implies that it should not be interpreted as a signal of a deterioration of the global macroeconomic environment, but rather a specific problem isolated within energy markets.

While there are some similarities with the 2014 supply glut, some major differences emerge. For one, OPEC is much more

18 **A speculative reversal added fuel to the fire**



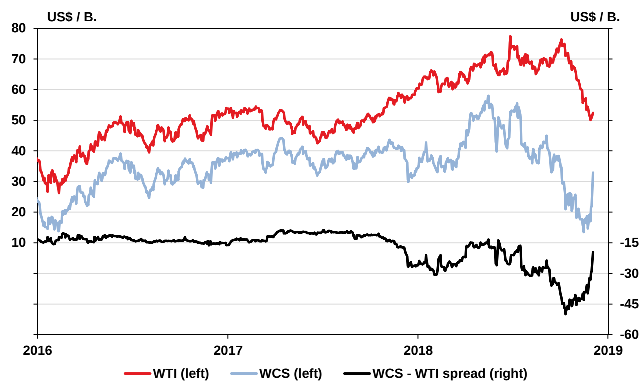
Source: Datastream

active in trying to stabilize prices. December 6 is circled on many calendars as it marks the date when the Cartel members meet.

While Saudi Arabia cautiously advised that it will not cut oil output without some form of cooperation from other members, the consensus is that the Cartel will have no choice but to act to limit the losses.

Canada is also active, as the Albertan government announced over the weekend a coordinated 325,000 barrels per day cut from companies in the province (**chart 19**). The objective is to ensure that the WCS to WTI discount narrows by diminishing inventory overhang. The plan ensures that they get drawn out just in in time for new exporting venues, such a pipelines, kick in.

19 **An immediate reaction to Alberta's announcement**



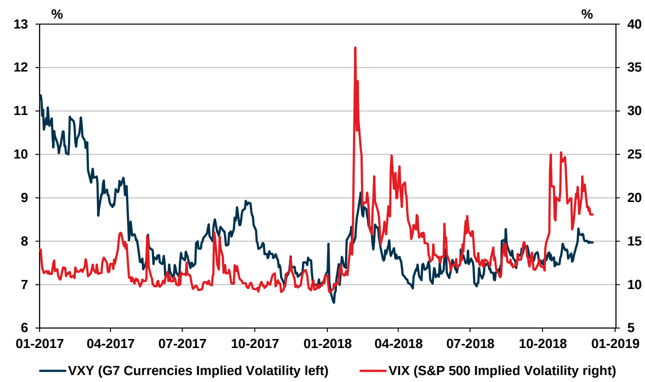
Source: Datastream

Considering that most of the bad news is behind us, we believe the next quarters will see crude prices increasing, as they will benefit from OPEC support and a reversal of the temporary downside pressures we have recently witnessed.

Currencies: In the Eye of the Storm

Despite the turmoil in most financial markets, currencies have relatively muted movements (**chart 20**), as it seems that most of them are facing conflicting forces.

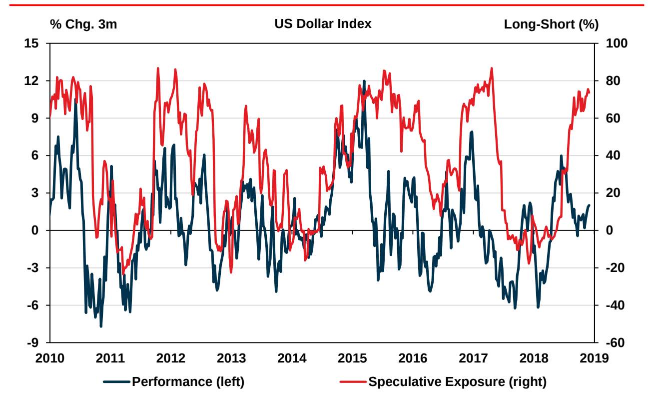
20 **Financial markets turmoil didn't translate to currencies**



Source: Datastream

For example, the greenback certainly benefitted from the risk-off mindset, but the 2.2% move since the beginning of October was smaller in light of a slower series of hikes than initially expected. Going forward, we still believe the U.S. dollar will weaken, especially as speculative length is reaching the top of its historical range (**chart 21**) and the support from a risk-off mindset should slowly fade away.

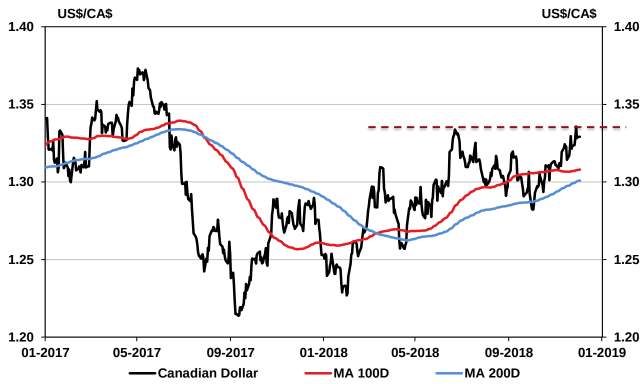
21 **Speculative lenght should act as a headwind for the USD**



Source: Datastream

For the loonie, crude oil's woes have weighed down the potential for upside as the currency is now close to year-to-date lows (**chart 22**, next page). As we said multiple times, the rate differential has much more influence on the value of the pair than energy prices, but the recent crude oil drop is large enough that it could affect monetary policy down the road and, consequently, the value of the Canadian dollar.

22 **A floor in the making for the Loonie?**



Source: Datastream

Despite the current environment, we expect energy products to rebound in the coming months (including the WCS to WTI spread) and the currency should follow, especially given our opinion that the U.S. dollar will weaken