NATIONAL BANK

ASSET ALLOCATION STRATEGY

February 1, 2018

So Goes January, so Goes the Year?

Highlights

- 2018 got off to a flying start, with U.S. equities delivering their best January since 1989. Lessons to draw from history are that after such a strong start, in all cases, the index finished the year in positive territory, but we should brace for a volatility comeback.
- Explanations for such stellar performance are numerous. For one, the world economy is firing on all cylinders. For another, earnings expectations have been strongly revised upward.
- Yet, one can't help but feel that things are starting to look a little stretched, as the S&P 500 hasn't seen a 5% pullback in more than 400 consecutive days – its longest streak ever!
- One area of risk for risk assets in 2018 could be rising nominal interest rates. Everything points to higher inflation in the coming months which suggests that the Federal Reserve will likely hike a few more times in 2018. Therefore, the 3% technical resistance is very much within reach.
- The U.S. dollar continued its downtrend by posting a third consecutive, negative monthly print in January. The story here is that the monetary policy divergence that pushed the greenback higher is now dissipating, as growth in Europe is surprisingly strong and is forcing the ECB to consider reducing the timeline for policy normalization.
- The loonie has been on a tear since mid-2017, due to tailwinds caused by the commodity resurgence and a better-than-expected economic rebound, but the next big move will depend on economic surprises on both sides of the border.
- Most oil exporting countries have benefitted in recent months and now enjoy some breathing room fiscally. Unfortunately, Canada is one of the unlucky ones. Western Canadian producers are facing a bottleneck with no clear solution available in the near future.
- Although the statistical case for mean reversion in equity prices is becoming self-evident, we continue to believe this bull run has upside. One argument supporting that view is the many similarities the current equity cycle is showing with the 1987 to 2000 S&P 500 record run, with one exception: fundamentals are better today!
- We bring back our overweight TSX to neutral. Other than the oil price dynamics, perhaps the negative perception on the part of international investors, of things overshadowing the Canadian economy–whether it is NAFTA, household indebtedness, or home prices–will have to dissipate somewhat before the TSX can actually assume leadership.

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		■			
Currency Hedge			■		
Commodities			■		
Energy			■		
Base Metals			▒	■	
Gold			■		
Infrastructure			■		

Source: CIO Office

Current Allocation ■

Previous Month Allocation ▒

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Market Review

Fixed income

- U.S. 10-year treasury yields climbed past 2.70% for the first time since April 2014, finishing the month up 31 bps from their 2017 close, with the combination of a weaker dollar and tax cuts adding weight to inflation expectations.
- Canadian rates also crept higher, with the 10-year benchmark closing at 2.29%, and the Bank of Canada hiking its policy rate by .25% for the third time in six months amid upbeat economic data.

Canadian equities

- Canada's main stock index eased slightly in January, missing the rally in global equities as weakness in the Energy sector acted like a millstone around its neck.
- Interest-sensitive and defensive sectors such as Telecom and Utilities came under pressure in January, while the little-weighted Technology stocks had the only significant gains.

U.S. equities

- Racking up the best year's start since 1989, the S&P 500 rallied impressively last month with a 5.6% price return (5.7% total return) supported by material revisions in forward earnings as tax reform effects become clearer.
- Consumer Discretionary, Healthcare, Technology, and Financials stocks led the surge, while only REITs and Utilities companies edged lower.

Commodities

- WTI crude oil closed out January above $64/bbl, the highest since December 2014, with rising demand and a weaker U.S. dollar giving a strong tailwind to prices.
- The weaker dollar also nudged gold prices higher, finishing the month up 3.0% at $1,345/ounce.

Foreign exchange

- The greenback began 2018 where 2017 left off: under broad pressure and declining 3.2% in January ahead of Janet Yellen's last Fed meeting and amid strong economic momentum outside the U.S.
- In Canada, despite some NAFTA-induced volatility early in the month, the loonie finished at a four-month high of 81.2¢ U.S. after November's GDP report showed economic growth bounced back from October's flat reading.

Table 2 Market Returns

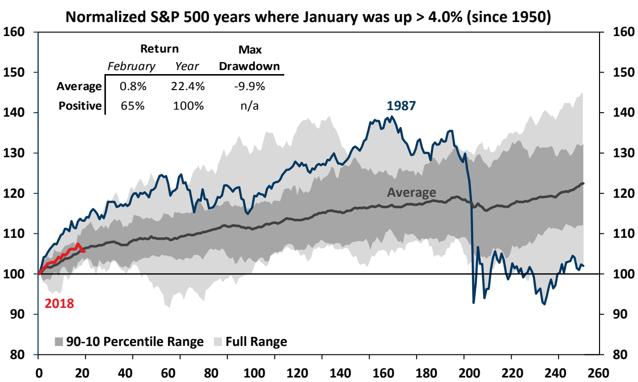
Asset classes	January	12 months	2017
Cash (3-month T-bills)	0.1%	0.6%	0.6%
Bonds (FTSE/TMX Ovr. Univ.)	**-0.8%**	**1.8%**	**2.5%**
FTSE/TMX Short term	-0.2%	-0.4%	0.1%
FTSE/TMX Mid term	-1.1%	-0.4%	1.0%
FTSE/TMX Long term	-1.4%	6.4%	7.0%
FTSE/TMX Government	-1.0%	1.5%	2.2%
Federal	-0.8%	-0.5%	0.1%
Provinces	-1.3%	3.6%	4.3%
Municipales	-1.1%	3.9%	4.7%
FTSE/TMX Corporate	-0.2%	2.7%	3.4%
AA+	-0.2%	0.1%	0.7%
A	-0.3%	3.8%	4.4%
BBB	-0.1%	3.2%	4.0%
BoAML High-Yield (USD)	0.7%	6.7%	7.5%
Preferred shares	1.6%	10.9%	13.6%
Canadian Equities (S&P/TSX)	**-1.4%**	**6.7%**	**9.1%**
Energy	-5.4%	-6.9%	-7.0%
Industrials	-1.8%	16.9%	19.7%
Financials	0.8%	11.6%	13.3%
Materials	-0.6%	-2.1%	7.7%
Utilities	-4.3%	4.5%	10.8%
Cons. Disc	-0.3%	23.0%	22.8%
Cons. Staples	-1.9%	7.3%	7.8%
Healthcare	-4.1%	33.2%	34.2%
IT	5.4%	22.8%	16.8%
Telecom	-4.5%	6.7%	14.8%
REITs	-1.9%	8.8%	10.8%
S&P/TSX Small cap	-2.2%	0.0%	2.8%
US Equities (S&P500 USD)	**5.7%**	**26.4%**	**21.8%**
Energy	3.8%	6.6%	-1.0%
Industrials	5.3%	25.7%	21.0%
Financials	6.5%	29.8%	22.2%
Materials	4.1%	23.3%	23.8%
Utilities	-3.1%	7.3%	12.1%
Cons. Disc	9.3%	29.0%	23.0%
Cons. Staples	1.6%	13.4%	13.5%
Healthcare	6.6%	27.3%	22.1%
IT	7.6%	43.1%	38.8%
Telecom	0.5%	1.8%	-1.3%
REITs	-1.9%	8.8%	10.8%
Russell 2000 (USD)	2.6%	15.7%	13.1%
World eq. (MSCI ACWI)	**5.7%**	**28.1%**	**24.6%**
MSCI EAFE (USD)	5.0%	28.2%	25.6%
MSCI EM (USD)	8.3%	41.5%	37.8%
Commodities (CRB index)	**2.5%**	**2.3%**	**2.2%**
WTI oil (US$/barrel)	7.2%	22.9%	12.5%
Gold (US$/ounce)	2.9%	10.7%	12.6%
Copper (US$/tonne)	-1.8%	18.1%	30.5%
Forex (DXY - US Dollar index)	**-3.2%**	**-10.4%**	**-9.9%**
USD per EUR	3.7%	15.3%	13.8%
CAD per USD	-2.1%	-5.5%	-6.4%

Source: Datastream 1/31/2018

So Goes January, so Goes the Year?

2018 got off to a flying start, with U.S. equities delivering their best January since 1989. While that price surge is surely impressive, it is not unprecedented. Since 1950, there have been 20 instances where the S&P 500 began the year with a price return above 4%. Lessons to draw from history are that: (1) after such a strong start, February returns are typically much more modest, yet generally positive; (2) in all cases, the index finished the year in positive territory, with an average price return of 22.4%; and (3) we should brace for a volatility comeback, with an average intra-year drawdown of 10% (**chart 1**). The most notable example is 1987, in which despite crashing 33.5% from peak to trough, the S&P 500 managed to finish the year positively along with economic growth.

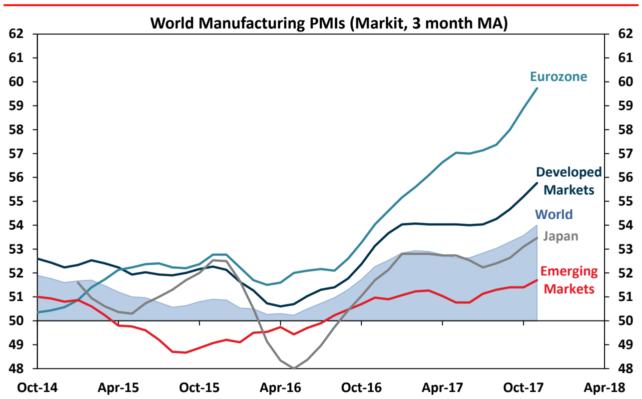
1 Lessons to draw from previous strong start to a year



Source: Bloomberg

Explanations for such stellar performance are numerous. For one, the world economy is firing on all cylinders: in the United States, after a weaker-than-expected 2.6% quarterly clip at the end of 2017, the Atlanta Fed (based on information gathered so far in January) is estimating growth at 4.2% for the first quarter of 2018; in Europe and Japan, manufacturing activity continues to trend further up, along with emerging markets (EM) also benefitting from easier monetary conditions (**chart 2**).

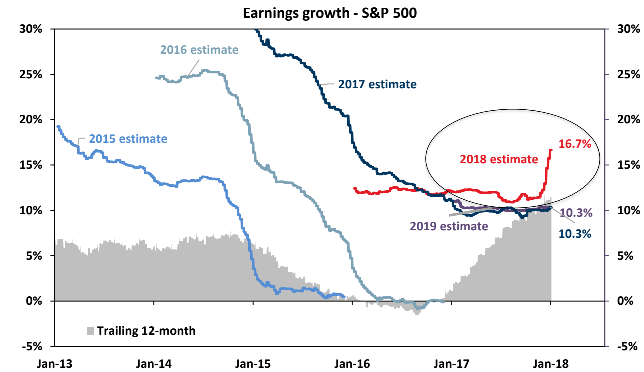
2 The world economy is firing on all cylinders



Source: Datastream

For another, earnings expectations have been strongly revised upward (**chart 3**) following the adoption of the Tax Cuts and Jobs Act (TCJA) in the United States at the end of 2017. The weaker greenback is also helping.

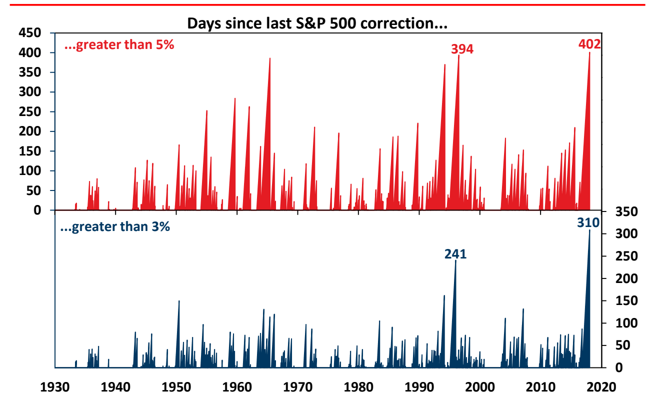
3 Tax reform benefits kicking in



Source: Datastream

Yet, one can't help but feel that things are starting to look a little stretched. After all, the RSI of the S&P 500 in January reached its highest level in the past 40 years, and the stock index hasn't seen a 5% pullback in more than 400 consecutive days – its longest streak ever (**chart 4**).

4 Longuest streak ever without a 5% pullback

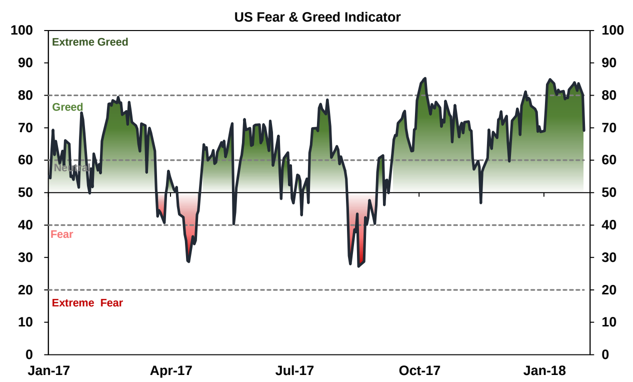


Source: Bloomberg

Meanwhile, our Fear & Greed indicator continues to suggest a little bit of complacency on the part of investors (**chart 5, next page**), a signal that is also reflected in the latest AAII surveys of Bulls and Bears (**chart 6, next page**).

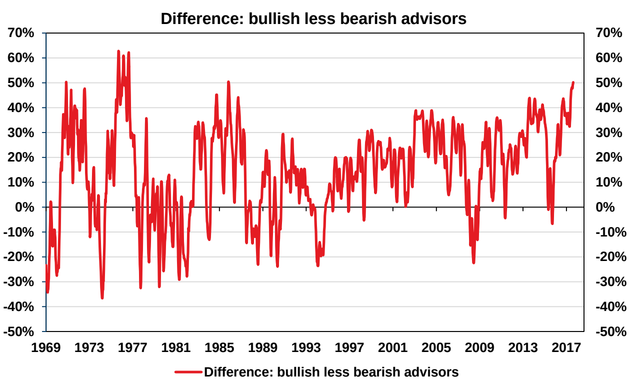
So the big question is not 'why,' but 'what next?' As we feel January was a one-off readjustment to lower corporate taxes and stronger economic growth than expected, we are probably back to square one in terms of expectations for the rest of the year.

5 **The market has been « greedy » for quite some time…**



Source: Bloomberg

6 **… and advisors have never been this bullish since 1986**

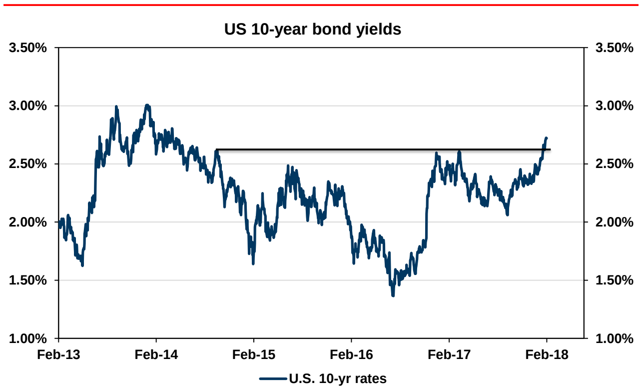


Source: Datastream

Fixed Income: The Path of Least Resistance is Up

One area of risk for risk assets in 2018 could be rising nominal interest rates. Certainly, by all means, bond yields also look stretched with the U.S. 10-year notes rising above 2.70% for the first time since 2014 (**chart 7**), resulting in the 2.40% loss in January.

7 **10-year notes above 2.70% for the first time since 2014**

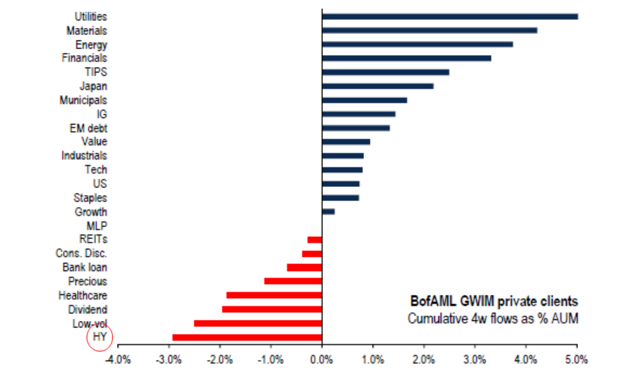


Source: Datastream

However, everything points to higher inflation in the coming months which suggests that short-term real interest rates are too low at this stage of the business cycle and the Federal Reserve will likely hike a few more times in 2018. This means that, barring an exogenous shock, the path of least resistance for yields is up, and the 3% technical resistance is very much within reach.

Therefore, we advise staying underweight on government bonds. A shorter-duration, higher-coupon, investment-grade strategy still makes sense in a rising rate environment. We also remain cautiously neutral on high-yield issuers as flows are ebbing (**chart 8**) and spreads are compressing.

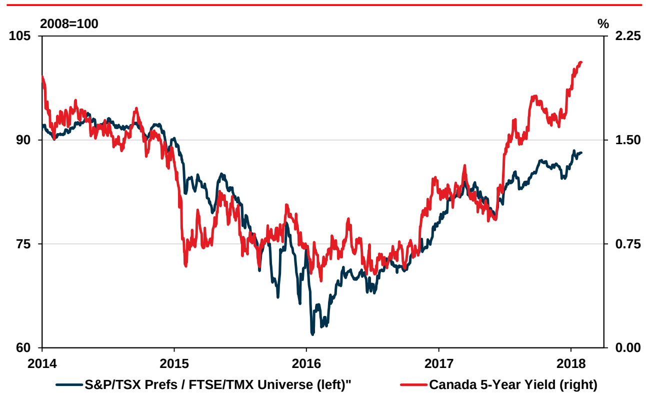
8 **High yield flows are ebbing**



Source: Bank of America Merrill Lynch

We continue to favour non-traditional or unconstrained fixed-income solutions, where investors can either access credit-spread strategies with no interest rate risk, or more stable higher coupons outside of Canada. If you'd rather stay "home" and limit the cost of hedging, preferred shares also still hold a lot of potential in light of further upcoming Bank of Canada interest rate hikes (**chart 9**).

9 **Prefs a good bet in a rising rate environment**



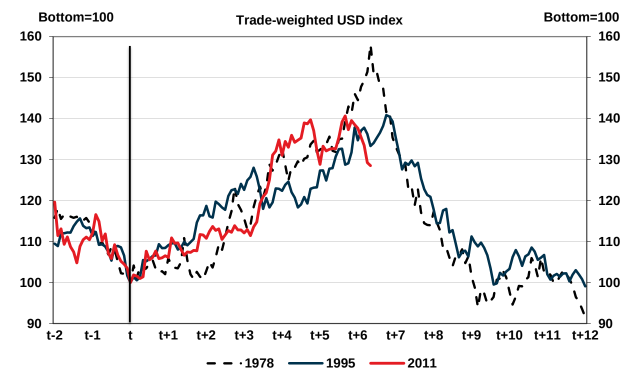
Source: Datastream

Currencies: The Greenback Seeing Red

Recent moves in currencies also look overdone. The U.S. dollar continued its downtrend by posting a third consecutive, negative monthly print in January. The index is now 13% lower from the last year's top.

This may surprise some, considering the Fed raised rates faster than was expected at the beginning of 2017. However, more and more signs are pointing toward confirmation of the end of the USD bull market, and history shows time is on the bear's side (**chart 10**).

10 U.S. Dollar: History shows time is on the bear's side



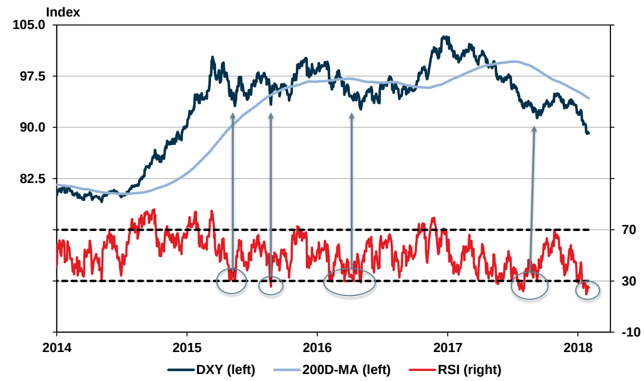
Source: Datastream

The story here is that the monetary policy divergence that pushed the greenback higher is now dissipating, as growth in Europe is surprisingly strong and is forcing the ECB to consider reducing the timeline for policy normalization. In fact, the Eurozone is not the only one benefitting from economic tailwinds as synchronized growth has taken hold around the globe. Such an environment is usually tied to greenback weakness and we've seen that story before. For example, as we discussed in last month's letter, no OECD country was in contraction in 2017, and the last time we witnessed such an occurrence was during the 2004-2007 period which saw the USD lose 14%.

That being said, although downward forces are at work, a short-term rebound is possible. The DXY is in oversold territory (**chart 11**) and speculator positioning is also signalling a potential reversal as shorts are too high on an historical basis (**chart 12**).

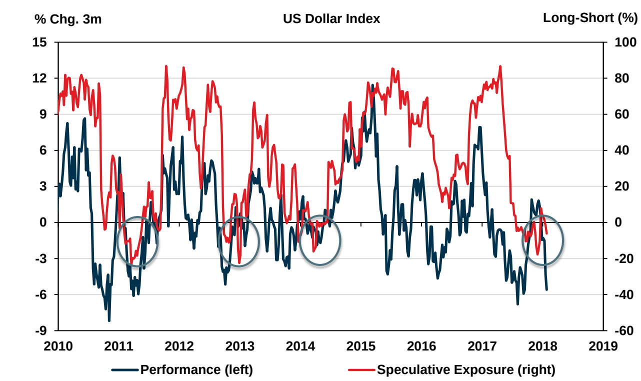
The loonie has been on a tear since mid-2017, due to tailwinds caused by the commodity resurgence and a better-than-expected economic rebound following the energy-downturn. While we expect overall commodity demand to remain strong via increasing emerging market demand, we doubt energy prices will have much impact on currency value in the near future (see next section).

11 Oversold DXY tends to either stabilize or rebound



Source: Datastream

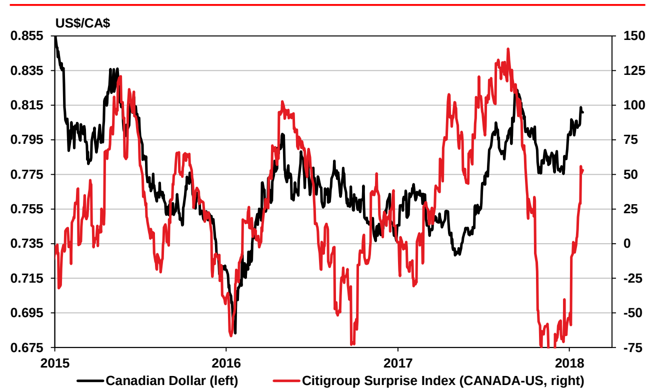
12 DXY usually rebounds from short positioning



Source: Datastream

As monetary policy divergence between Canada and the U.S. is now all but dissipated, the next big move will depend on economic surprises on both sides of the border (**chart 13**).

13 The state of both economies will dictate CAD direction

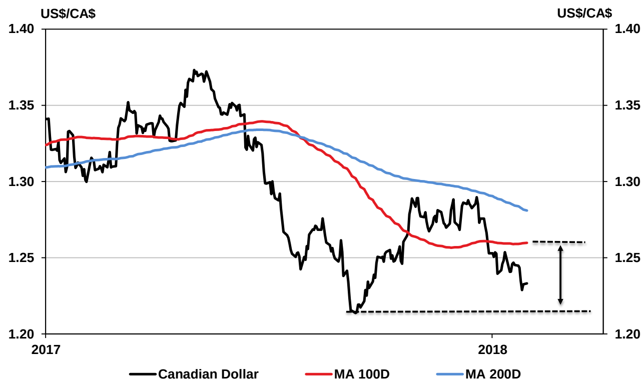


Source: Datastream

BoC Governor Poloz confirms this thesis as he once again emphasized data dependency regarding future hikes. Political risks are also on the forefront as NAFTA negotiations are still looming large and add a layer of complexity for the Central Bank. This is the main reason behind the BoC's cautious approach to future tightening.

Technically, we expect some resistance at $1.21, which should be tested if NAFTA-2 is finally agreed upon and signed. If the loonie were to weaken, the moving averages at 1.26 and 1.28 should act as support (**chart 14**).

14 Between 1.21 and 1.26 until NAFTA-2 is clearer



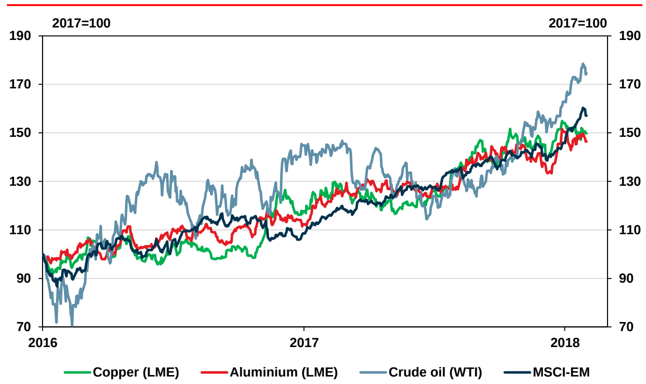
Source: Datastream

Consequently, until the situation clears up regarding the trade agreement, we think the currency will have a tendency to be range-bound.

Commodities: Complexity in the Oil Complex

Bolstered by increasing emerging market demand generated by an uptick in global growth and U.S. dollar weakness, commodities have posted handsome returns since the beginning of 2016 (**chart 15**).

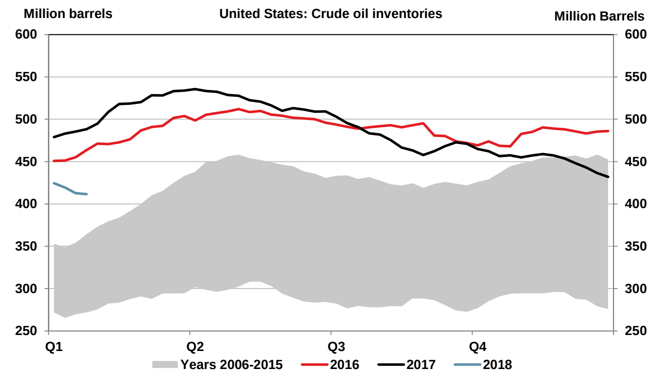
15 Commodities and EM: two great years!



Source: Datastream

For U.S. crude oil, inventories are inching closer towards normalization with each passing month (**chart 16**). Except for stocks and increased demand, nothing has changed much on the supply side in recent months. OPEC + Russia cuts are still having

16 Closing-in on pre-downturn numbers

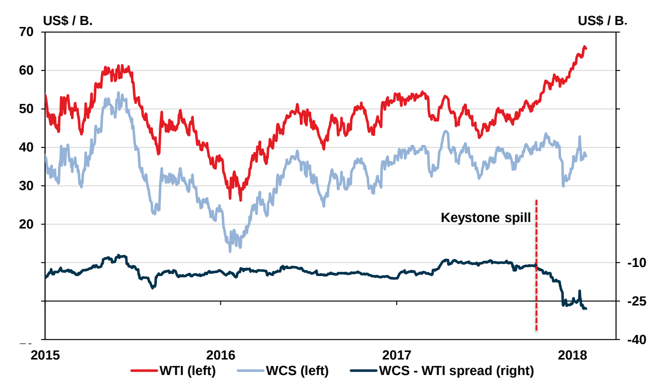


Source: Datastream

an effect and, while oil ministers have expressed resolve toward maintaining the agreement active until the end of 2018, many are now pondering their exit strategies as leaders have expressed willingness to follow a form of reliance on data, which is clearly improving. Going forward, the equilibrium remains somewhat intact, and the tug-of-war between U.S. shale oil and OPEC will be the main driver of prices in the next quarters. Until we see any change on that front, we expect prices to be range-bound.

What is clear is that most exporting countries have benefitted in recent months and now enjoy some breathing room fiscally. Unfortunately, Canada is one of the unlucky ones. For this reason, look no further than the price of Western Canadian Select (WCS). WCS represents the selling price that Canadian heavy crude oil producers are subjected to. As WCS is of lesser quality (heavy oil), it usually trades at a discount to the reference point of West Texas Intermediate (light oil, WTI). A discount exists because it is less expensive to refine light oil than heavy oil. Since November, the spread has widened materially (**chart 17**) for multiple reasons:

17 Keystone spill: the staw that broke the camel's back



Source: Datastream

1. **Rise in production.** Activity is expected to increase materially in the next years as producers plan to add north of 800,000 barrels per day production by 2020 (a 15% to 20% increase). These are legacy projects that were approved before the 2014 downturn.

2. **Loss of export capacity.** While production is expected to increase, capacity to ship out the product has stagnated or has even temporarily decreased. The spread started widening in November, which coincides with the Keystone Pipeline South Dakota spill. A company spokesman confirmed that the infrastructure is still only operating at 80% of normal output, which induces a loss of export volume of 70,000 bpd. The date of return to 100% capacity is still unknown. To compensate, producers have to ship by rail, which is much more expensive, and even that option is starting to show signs of reaching capacity constraints.

3. **Refineries can't pick up the slack.** Keeping oil in Canada to refine in-house is impossible as the country already produces in excess of its internal capacity, and it would take years for new projects' readiness.

Basically, Western Canadian producers are facing a bottleneck with no clear solution available in the near future. Until then, the discount of WCS to WTI needs to remain large enough to reflect higher transportation costs by train.

Equities: Record of Records

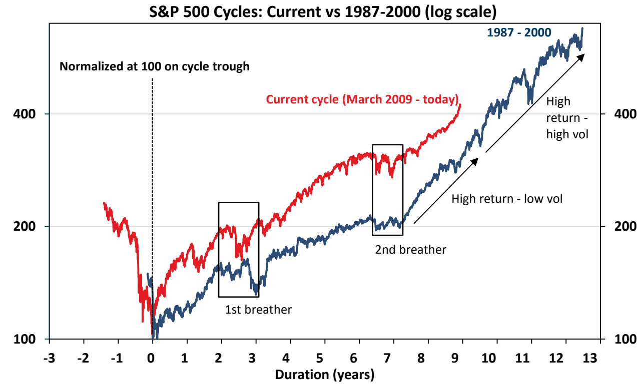
Although the statistical case for mean reversion in equity prices is becoming self-evident, we continue to believe this bull run has upside and would welcome, as the case may be, a short-term pullback as a sign of a healthy market.

Other than continued global growth and easy monetary conditions, one argument supporting that view is the many similarities the current equity cycle is showing with the 1987 to 2000 S&P 500 record run (**chart 18**). For instance, they both suffered similar pullbacks at similar points in time, in addition to a high return-to-vol period in their 8th and 9th year. Looking ahead, that precedent implies that we might be heading toward a period of exaggerated optimism characterized by high returns, but significantly more volatility. Indeed, the last 4 years of the period remembered for the tech bubble saw the S&P 500 gain 128%,[1] despite going through nine >5% corrections.

But, as the old saying goes, "history doesn't repeat itself but it often rhymes." And, one area where they differ is corporate fundamentals, which are in much better shape than they were in the "irrational exuberance" days. With 40% of the S&P 500 companies having reported their Q4 earnings, 79% delivered results that beat estimates, on track for solid 14.6% year-over-year growth (**chart 19**).

[1] From September 12, 1996 to March 24, 2000

18 1987-2000 suggest more upside… and more volatility



Source: Datastream

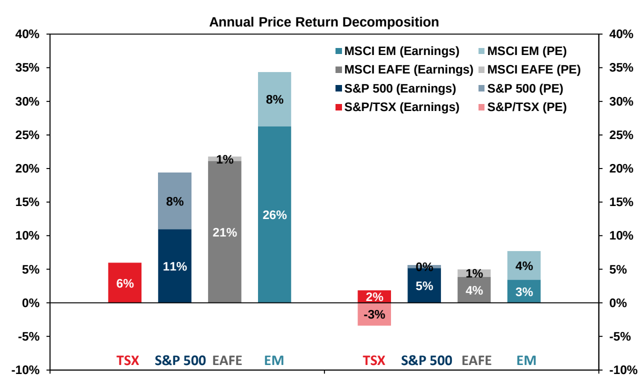
19 Corporate earnings on track for another solid quarter

	Reported (%)	Q4/17 YoY Earnings Growth (Blend Estimate)*	Beat (%)	Met (%)	Missed (%)
S&P 500	40%	14.6%	79%	9%	12%
Energy	16%	139.3%	100%	0%	0%
Materials	39%	30.5%	89%	0%	11%
Industrials	60%	15.3%	75%	6%	19%
Consumer Discretionary	21%	6.3%	75%	13%	13%
Consumer Staples	28%	10.3%	71%	29%	0%
Health Care	36%	4.5%	90%	5%	5%
Financials	65%	14.1%	79%	7%	14%
Information Technology	53%	21.1%	84%	13%	3%
Telecommunication Services	67%	6.2%	50%	0%	50%
Utilities	13%	8.3%	67%	0%	33%
Real Estate	27%	-2.1%	56%	22%	22%

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

As a matter of fact, the bulk of 2017 returns from global equity benchmarks was made on the back of earnings growth rather than plain PE expansion, reflecting the soundness of the last year rally (**chart 20**).

20 Returns continue to be fuelled by earnings growth



Source: Datastream

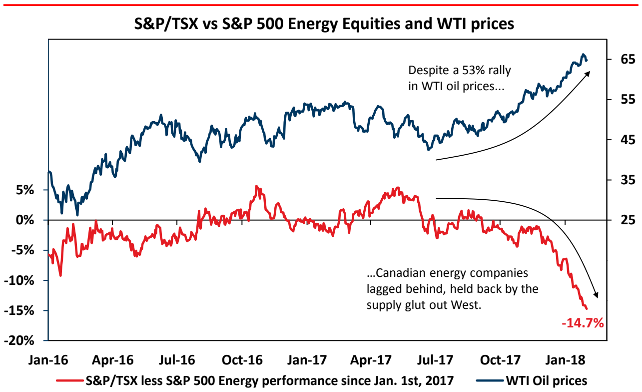
Meanwhile, Canada continues to lag its counterparts as the only index negatively affected by PE contraction, more than offsetting the 2% increase in S&P/TSX forward earnings year-to-date.

Back in December 2017, we stated that:

> *"[…] we call for patience and maintain our bias in favour of Canada, despite our level of conviction diminishing in light of consistent downward revisions to S&P/TSX Energy earnings. […] our positioning was tactical (3-6 months horizon): if momentum doesn't reverse, this will increasingly look like a value trap in which case we would revert back to neutral."*

Since then, the supply glut out West continued to act as a tear in the side of Canadian Oil & Gas heavyweights, preventing them from benefitting from a rally in WTI prices (**chart 21**).

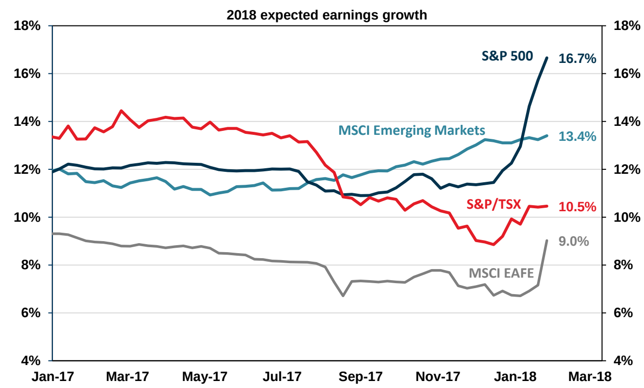
21 Canadian energy stocks deprived from the crude rally



Source: Datastream

Accordingly, we've seen S&P/TSX expected earnings growth for 2018 go from first to third position, significantly behind the U.S. and EMs, two benchmarks heavily benefitting from a dominant technology sector virtually absent in Canada (**chart 22**).

22 2018 expected earnings growth



Source: Datastream

At this point, despite attractive relative valuation and a pro-cyclical tilt, we believe we may have been a little bit too early in overweighting the TSX. Other than the oil price dynamics, perhaps the negative perception on the part of international investors, of things overshadowing the Canadian economy–whether it is NAFTA, household indebtedness, or home prices–will have to dissipate somewhat before the TSX can actually assume leadership.

As such, we bring back to neutral our Canadian equity tactical recommendation in favour of persistency in momentum in other regions. Other than the United States, which should continue to thrive in 2018 because of lower taxes, EMs are also holding a lot of potential. While relatively more expensive than last year, the weaker U.S. dollar, the rise in commodity prices and accelerating growth are all supportive of further gains in the near future.

We continue to overweight equities, as both corporate fundamentals and the economic backdrop suggest this bull market has room to grow. But, the speed and magnitude at which stocks surged lead us to a sense of caution.