NATIONAL BANK

ASSET ALLOCATION STRATEGY

January 3rd, 2018

Cautiously optimistic for 2018

Highlights

- Last year, despite some monetary accommodation withdrawal from certain major central banks, the goldilocks scenario of a very strong growth and controlled inflation helped equities outperform treasuries for a 6th year in a row.
- In the coming year, we believe risk assets should continue to outperform, as the economic and financial backdrop remains healthy. But, as we are getting closer to the latter stages of the business cycle amid high levels of bullishness within the investing community, elevated equity valuations, and historically low volatility, investors should brace themselves for downside surprises.
- In that context, we are starting the New Year pretty much the way we ended the last:

– We remain overweight equities vs bonds.

– In fixed income, we are expecting a slight pick-up in yields but, unless inflation surprises on the strong side, we advise against being too short in duration.

– One way to play this would be to overweight U.S. IG credit (fully hedged), which offers higher yields to maturity than their Canadian counterparts, but we will likely switch back to Government bonds, duration neutral, as yields go up.

– WTI oil prices will likely test the US$60-US$65 range early in 2018, but we don't expect them to be much firmer on average throughout the year, as production from U.S. and OPEC producers could easily be increased.

– A tired USD, stable oil prices and more rate hikes than currently priced for the Bank of Canada could mean that the Loonie will appreciate gradually this year.

– In equities, as the Value style is becoming increasingly cheap vs Growth, we continue to like the TSX, for which the Energy and Financial sectors should benefit from a rise in inflation.

– With the U.S. dollar most likely in its last innings, we feel emerging markets could continue to catch up to developed markets in the foreseeable future. We start the year with a neutral approach, as China is showing signs of a slowdown, but will likely buy on dips.

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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2017 Market review

Fixed Income

- A flattening yield curve amid policy normalization by the Federal Reserve sums up the year for fixed income. Ten-year rates finished almost exactly where they started the year at 2.41%, while three rate hikes by the FED pushed three month T-Bills yield 89 bps higher in 2017.
- Similar story in Canada, with 3-month and ten-year rates up 60 bps and 33 bps, respectively, though the two rate hikes by the Bank of Canada were more of an “oil shock insurance” removal than policy normalization.

Canadian equities

- All S&P/TSX sectors barring Energy delivered positive returns this year, a majority (8/11) in the double-digit range. Signs of improving economic conditions have helped propel Canadian equities to new highs, especially during the last four months of 2017.
- It’s been a particularly good year for Consumer Discretionary and Industrials stocks, while the December surge in Valeant shares helped the Healthcare index climb out of hardship.

U.S. equities

- U.S. stocks recorded a total return of 21.8% for 2017, their best performance since 2013.
- Despite taking a breather in the last two months of 2017, technology stocks led the pack by a wide margin, up 38.8%, followed by Materials (+23.8%) and Consumer Discretionary (+23.0%). On the flip side, Telecom and Energy stocks recovered somewhat in December, but not enough to finish the year positive.

Commodities

- Oil prices closed 12.5% higher than a year before and 42% above their June 2017 trough, as supply curbs by global producers and rising demand have helped to stabilise the market.
- Robust economic growth, especially out of China, also favoured copper prices which had their best year since 2010.
- Gold prices gained a decent 12.6% in 2017, benefiting from a weaker U.S. dollar and, to a lesser extent, rising geopolitical tensions.

Foreign exchange

- The U.S. dollar index had its worse year since 2003, down 9.9%. On the other side of the Atlantic, the Euro closed its best year in a decade, up 14.1% against the greenback.
- The Loonie also gained this year, up 6.4% and finishing inches below the 80 U.S. cents mark, supported by oil prices and narrowing rates differential with the U.S.

Table 2 **Market Returns**

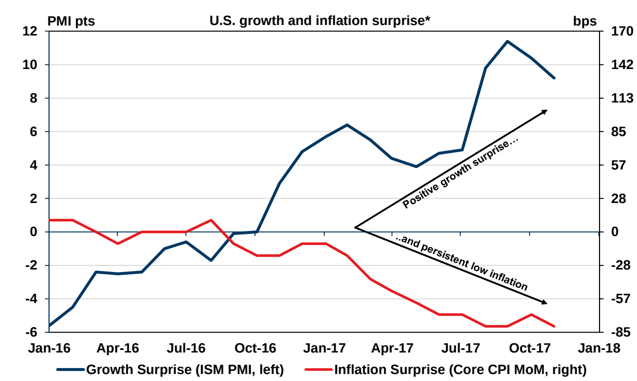
Asset classes	December	2017	2016
Cash (3-month T-bills)	0.0%	0.6%	0.5%
Bonds (FTSE/TMX Ovr. Univ.)	**-0.4%**	**2.5%**	**1.7%**
FTSE/TMX Short term	-0.5%	0.1%	1.0%
FTSE/TMX Mid term	-0.9%	1.0%	1.6%
FTSE/TMX Long term	0.0%	7.0%	2.5%
FTSE/TMX Government	-0.4%	2.2%	0.9%
Federal	-0.6%	0.1%	0.0%
Provinces	-0.2%	4.3%	1.8%
Municipales	-0.3%	4.7%	2.0%
FTSE/TMX Corporate	-0.4%	3.4%	3.7%
AA+	-0.6%	0.7%	2.0%
A	-0.3%	4.4%	3.6%
BBB	-0.3%	4.0%	5.1%
BoAML High-Yield (USD)	0.3%	7.5%	17.5%
Preferred shares	0.1%	13.6%	7.0%
Canadian Equities (S&P/TSX)	**1.2%**	**9.1%**	**21.1%**
Energy	1.1%	-7.0%	35.5%
Industrials	2.3%	19.7%	22.8%
Financials	0.7%	13.3%	24.1%
Materials	3.7%	7.7%	41.2%
Utilities	-0.9%	10.8%	17.7%
Cons. Disc	-0.5%	22.8%	10.7%
Cons. Staples	0.0%	7.8%	7.5%
Healthcare	24.2%	34.2%	-78.4%
IT	0.4%	16.8%	5.2%
Telecom	-1.1%	14.8%	14.7%
REITs	-0.5%	10.8%	3.4%
S&P/TSX Small cap	2.6%	2.8%	38.5%
US Equities (S&P500 / USD)	**1.1%**	**21.8%**	**12.0%**
Energy	4.9%	-1.0%	27.4%
Industrials	1.9%	21.0%	18.9%
Financials	2.0%	22.2%	22.8%
Materials	1.9%	23.8%	16.7%
Utilities	-6.1%	12.1%	16.3%
Cons. Disc	2.4%	23.0%	6.0%
Cons. Staples	2.2%	13.5%	5.4%
Healthcare	-0.6%	22.1%	-2.7%
IT	0.0%	38.8%	13.8%
Telecom	5.8%	-1.3%	23.5%
REITs	-0.5%	10.8%	3.4%
Russell 2000 (USD)	-0.6%	13.1%	19.5%
World eq. (MSCI ACWI)	**1.6%**	**24.6%**	**8.5%**
MSCI EAFE (USD)	1.6%	25.6%	1.5%
MSCI EM (USD)	3.6%	37.8%	11.6%
Commodities (CRB index)	**0.6%**	**2.2%**	**12.9%**
WTI oil (US$/barrel)	5.3%	12.5%	44.8%
Gold (US$/ounce)	1.9%	12.6%	9.0%
Copper (US$/tonne)	7.0%	30.5%	17.4%
Forex (DXY - US Dollar index)	**-1.0%**	**-9.9%**	**3.6%**
USD per EUR	0.7%	13.8%	-2.9%
CAD per USD	-2.5%	-6.4%	-2.9%

Source: Datastream 12/29/2017

2017: Better-than-expected on many fronts

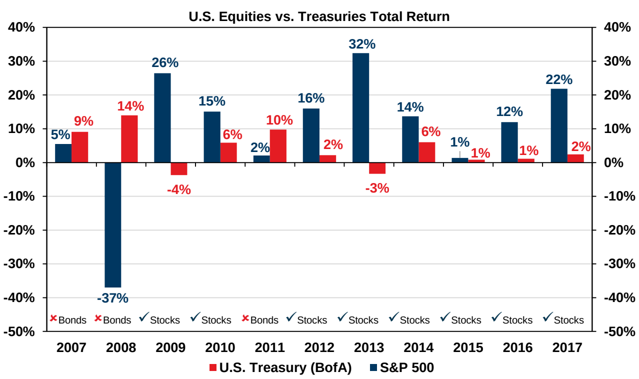
Last year, despite some monetary accommodation withdrawal from certain major central banks, the goldilocks scenario of a very strong growth and controlled inflation helped equities outperform treasuries for a 6th year in a row (**chart 1 and chart 2**).

1 2017 Goldilocks economic condition…



Source: Datastream *Surprise measured by the last 12-month sum of the difference between actual figures and reuters poll median estimates.

2 …led equities to extend their winning streak

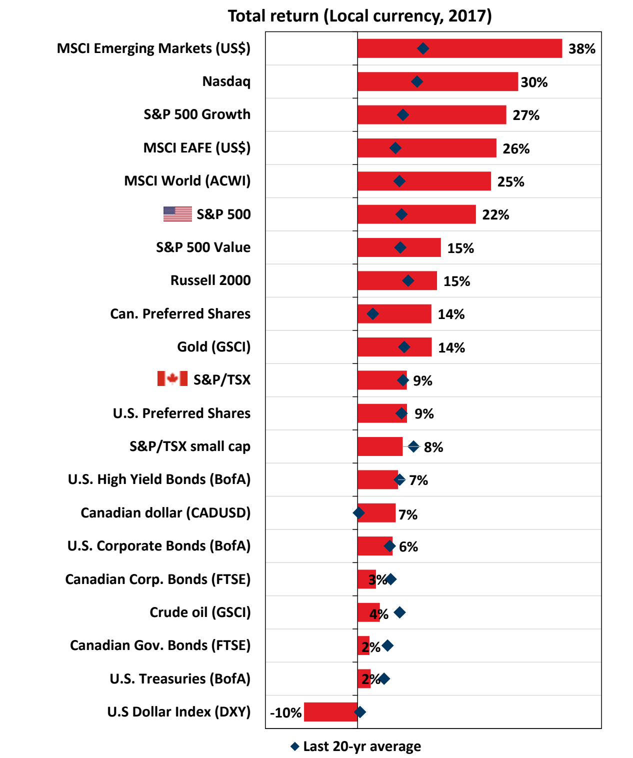


Source: Datastream

More specifically, Emerging Market equities ranked first among major asset classes (yes, that excludes the 1830% price surge in Bitcoins), followed by the NASDAQ and the S&P 500 Growth, all posting returns well above their historical averages (**chart 3**). That podium reflects the fact that the clear winners in 2017 are actually technology stocks, which accounts for about 28%, 46%, and 37% of the MSCI Emerging Markets, NASDAQ and S&P 500 growth indices, respectively. As mentioned in previous pieces, the mix of energy heavyweights and absence of tech giants explains most of the relative underperformance of Canadian equities this year. Still, the S&P/TSX finished with a decent 9.1% total return, in-line with its last 20-year average.

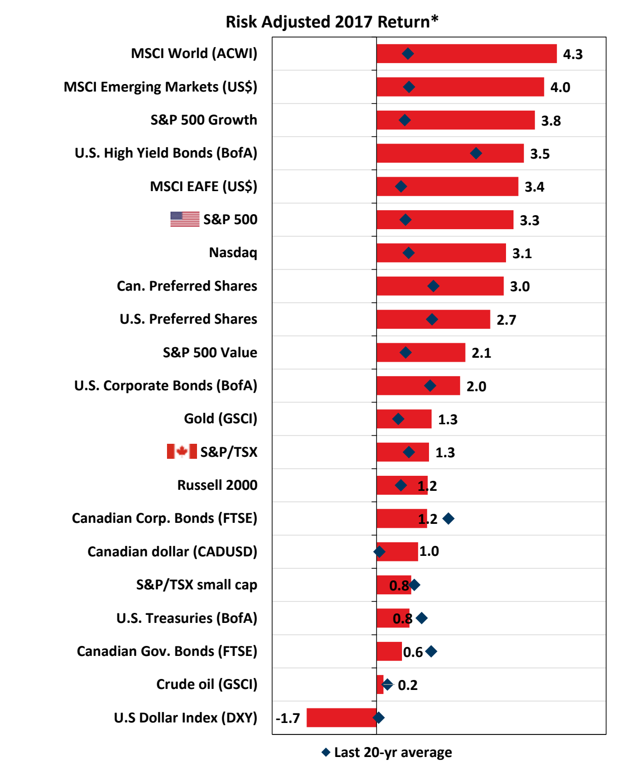
Without taking anything away from absolute returns, perhaps what distinguishes most of 2017 from previous years is the low level of volatility, hence the high risk-adjusted returns exhibited by most assets (**chart 4**).

3 Market performances in 2017



Source: Datastream.

4 Risk-adjusted market performances in 2017



Source: Datastream. **Risk adjusted return = 2017 total return divided by 2017 std. dev. of daily returns

For instance, you would have to go back to 1995 to see a better S&P 500 ratio, while the 4.3 achieved by the MSCI ACWI is unprecedented. It might seem surprising, given that news headlines were largely dominated by political uncertainty surrounding Brexit, North Korea, or virtually anything coming out of Washington. However, the truth is that 2017 is the year we saw the closing of the U.S. output gap, the best Eurozone GDP growth in a decade, the synchronisation of global manufacturing PMIs in growth territory, and oil prices stabilize in the 45/$60 range. In the end, economic fundamentals are what really matters, and last year was a good reminder.

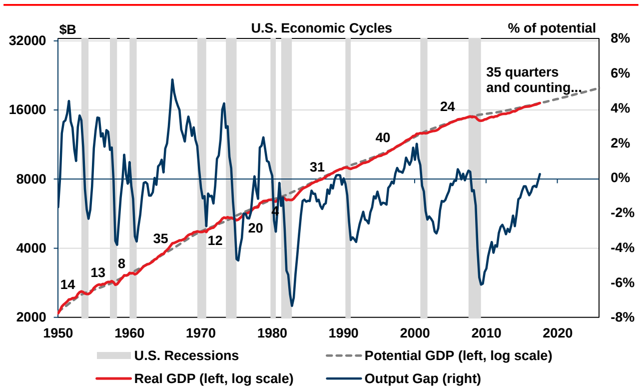
In the coming year, we believe risk assets should continue to outperform, as the economic and financial backdrop remains healthy. But, as we are getting closer to the latter stages of the business cycle amid high levels of bullishness within the investing community, elevated equity valuations, and historically low volatility, investors should brace themselves for downside surprises.

2018: Moving towards the late stage cycle…

Knowing precisely where we stand in the business cycle is always debatable, but the longer it gets, the more investors, analysts or strategists will tell you that the end is near and, therefore, that a stock market correction is inevitable. While we agree the latter will happen eventually, we question both the timing and the amplitude of any given market drawdown, and believe that a pullback would be more of an opportunity than a warning sign.

To put things in perspective, we first compare past episodes of the business cycle with the current environment to better understand where we lie. If you measure a cycle as the number of quarters between recessions, then the current episode is effectively the second longest in history, equal to the 1960s at 35 quarters, but still short of the 1990s record streak (**chart 5**).

5 The U.S. Economy has room to grow



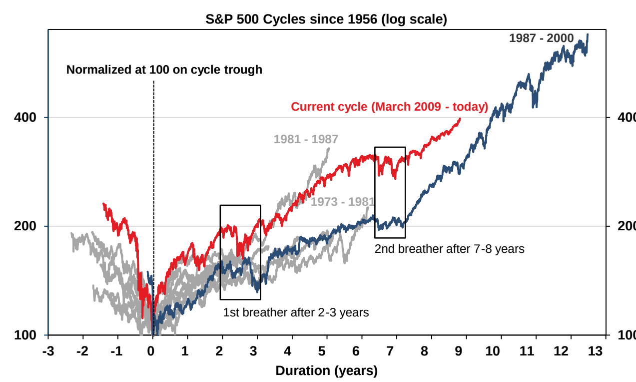
Source: Datastream

Accordingly, equity markets are also enjoying one of their longest runs ever with the S&P 500 price index up almost eight years and nine months without a 20% correction. On that basis, the current cycle surely looks stretched as equities have historically peaked once every five years, on average. However, bull markets don't die of old age, and there is little convincing us that the party is about to end.

For one thing, the fact that we just recently closed the output gap, while the FED is still in the first innings of its policy normalisation, suggests very little recession risk for the coming years.

For another, the number of days without a 20% correction observed since March 2009 can be a bit deceiving, as many stock indices worldwide entered bear market territory in 2015—namely U.S. small caps (-26%), the Canadian market (-24%), and the median U.S. stock (-26%)—and the only reason the S&P 500 didn't pullback as much (-16%) was because the five biggest stocks of the index managed to stay afloat. In essence, we believe this makes it much more comparable to the 1987–2000 period which, after similar "breathers" around the third and seventh years of the cycle, managed to increase for another four years (**chart 6**).

6 It's beginning to look a lot like 1987-2000

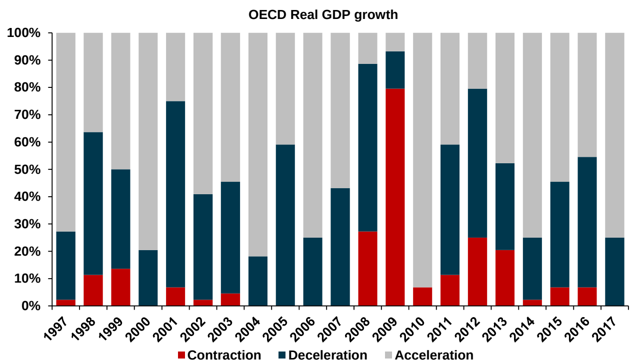


Source: Datastream

Another reason we feel confident the market still holds a lot of potential is that the synchronized global upswing should continue. In 2017, a diffusion index compiled by the OECD showed that 100% of the 42 countries surveyed had a growing GDP, a rare occurrence that tends to last a few years before it toggles into a synchronized slowdown (**chart 7,** next page).

Also, if you make adjustments for external shocks, then business cycles are in effect much more sustainable than they appear at first sight. A good example is the 1990 U.S. recession which was very mild in nature and would probably not have happened without the spike in oil prices that followed the Gulf War.

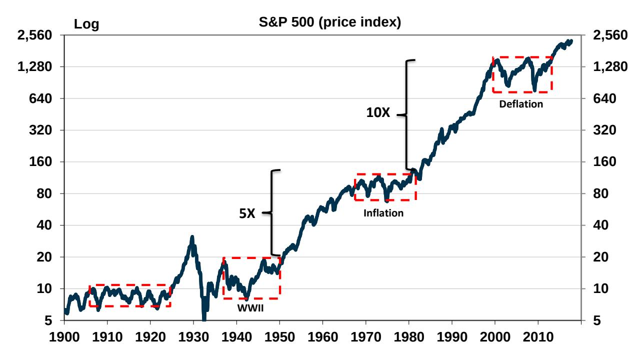
7 The synchronised global upswing should continue



Source: Datastream

Perhaps a better way to see things is that there are shorter cycles within longer ones. Going back to the early 1920s, we find that long cycles tend to follow periods of extreme market volatility caused by events such as world wars, strong inflation, or worse, deflation (**chart 8**). As such, after more than a decade of a seesaw trend in equity markets since the start of the millennium, the world economy seems to have finally licked its wounds from the global financial crisis, has fully recovered and, barring an unforeseen negative shock, looks set to grow much higher.

8 Periods of strain are followed by prosperity



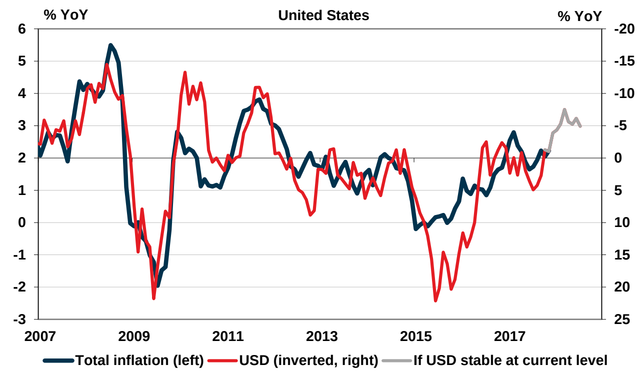
Source: Shiller

… has to be confirmed by rising inflation…

Ultimately, the business cycle will enter its last stage with the economy overheating, and inflation—a lagging indicator—picking up. For now, there is little evidence of inflationary pressure (**chart 9**), but 2018 may well be the year when we see things lining up.

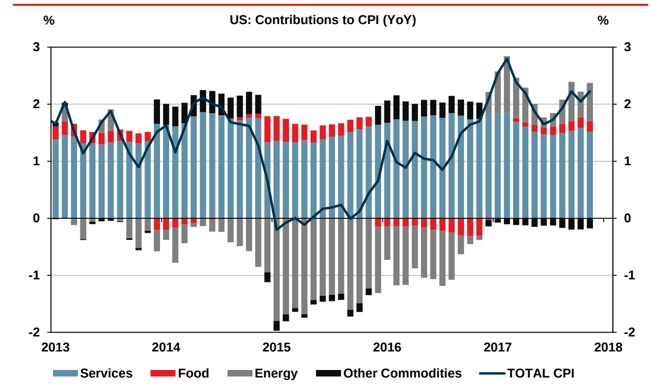
We start by reviewing different components of inflation to find out that the transitory effects of lower energy prices are now behind us and contribute to total inflation (**chart 10**).

9 Weaker USD should impact inflation figures in 2018



Source: Datastream

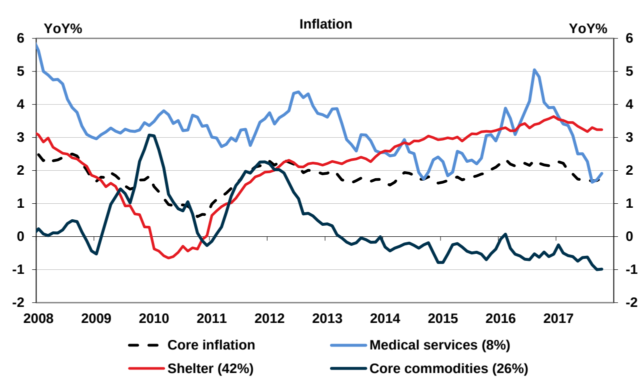
10 Energy prices transitory effects are now behind us



Source: Datastream

Meanwhile, core inflation, which excludes volatile components such as energy and food prices, remains subdued as the effect of globalization and online retailing is persistent. But one-time downward adjustments in services items, such as medical care and mobile phones, suggest the worse is likely behind us (**chart 11**).

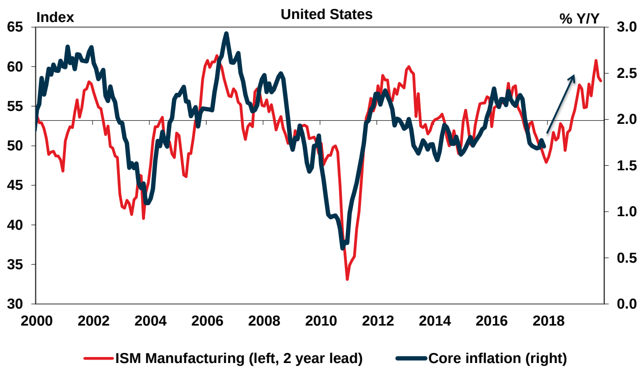
11 One-off events dragged inflation down in 2017



Source: Datastream

Above all, as inflation is a lagging indicator, today's softness mainly reflects the weakness of the U.S. economy about two years ago. However, growth has recovered well since then, and manufacturing indicators point towards an acceleration in inflation figures early in 2018 (**chart 12**).

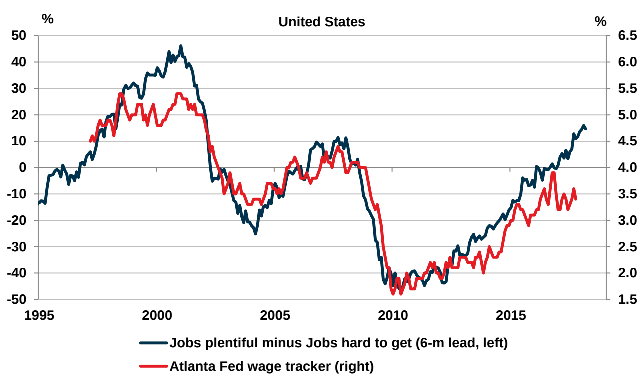
12 Faster growth will lead to higher inflation



Source: Datastream

Finally, we expect scarcity on the job market to exert upward pressure on wages. Particularly, the ratio of "jobs plentiful" relative to "jobs hard to get" has never been this high since 2002, yet wage tracker indices seem to stubbornly continue to show muted growth (**chart 13**).

13 Pressure on wages is up



Source: Datastream

As we expect inflation to firm up in 2018, major central banks should continue their gradual withdrawal of monetary policy accommodation. However, for as long as the level of key interest rates remain below the neutral rate, past monetary tightening episodes suggest it is not an impediment to higher markets as raising rates are offset by a faster growing real economy.

… but key factors are not flashing red yet

In fact, when we compare today's environment with the conditions that were prevailing in previous corrections, the current situation doesn't seem to be conducive to a significant pullback. To be sure, we've highlighted **market conditions** that prevailed during previous 20%+ S&P 500 corrections (**chart 14,** next page):

1- **A macro backdrop showing signs of overheating**.
The fact that many of the statistics of economic activity that we follow are near or at record levels is a cause for concern and bears close monitoring (**panel 2**). But, we are mainly momentum driven in our approach and history suggest the current state can persist for longer than expected. Still low capacity utilization, the just recent closing of the output gap and wage growth not accelerating suggest we may have a few more quarters ahead of us before a reversal.

2- **Central banks bringing monetary policy in restrictive territory leading to an inversion of the yield curve**.
At roughly 100 bps, the curve is very unlikely to invert in the coming months (**panel 3**). Most importantly, the 2006 episode showed that stocks can peak months after an outright negative curve, so there is no need to act preventively.

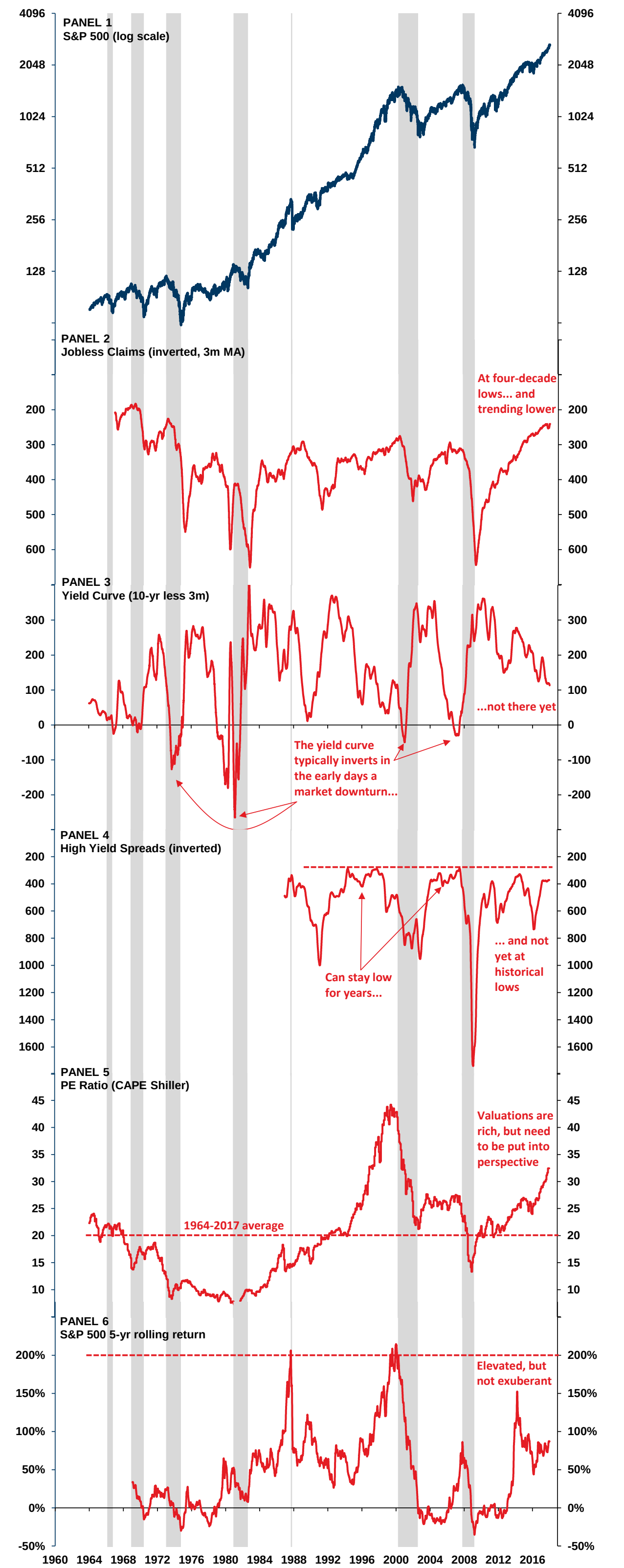
3- **Credit quality deteriorating markedly**.
U.S. high-yield spreads are low, but history shows that they can go lower, and stay there for years. Barring any unforeseen shock, credit quality is likely to remain healthy (**panel 4**).

4- **Equity valuations rising significantly above historical trend.**
Valuations are rich, but they need to be put into perspective. First, they remain cheap relative to their fixed income alternative, yielding roughly 300 bps more than U.S. 10-year treasuries. Second, with growth sectors such as Technology and Healthcare increasing in importance, it may be argued that the S&P 500 requires higher valuation metrics than back when it was almost entirely made of industrials, rails and banks. Finally, numerous studies demonstrate that valuations metrics have virtually no explanatory power below the 5–10 year horizon (**panel 5**).

5- **Investors showing irrational exuberance**.
With all-time high headlines almost every week, and close to nine years without a +20% correction, it's easy to believe that gains are exaggerated. At 87%, the last five years of equity returns are undoubtedly elevated, but nowhere near the 1987 and tech bubble exuberance (**panel 6**).

In short, nothing really is flashing red: macro fundamentals are still good; we're expecting a pick-up in inflation, but not the type of rise that would lead the market to think that the Fed is significantly behind the curve; the yield curve is flatter, but still ways from being inverted; credit spreads are tight, but still above historical lows; equities appear expensive compared to

14 Five key factors and historical market downturns



Source: Datastream. Shaded area represent S&P 500 downturns (peaks to troughs) greater than 20%.

history, but not so much when put into perspective; and the pace of past years' equity gains is not suggestive of speculation behaviour.

Tactical positioning for 2018

In that context, we are starting the New Year pretty much the way we ended the last:

- We remain overweight equities vs bonds.
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- One way to play this would be to overweight U.S. IG credit (fully hedged), which offers higher yields to maturity than their Canadian counterparts, but we will likely switch back to Government bonds, duration neutral, as yields go up.
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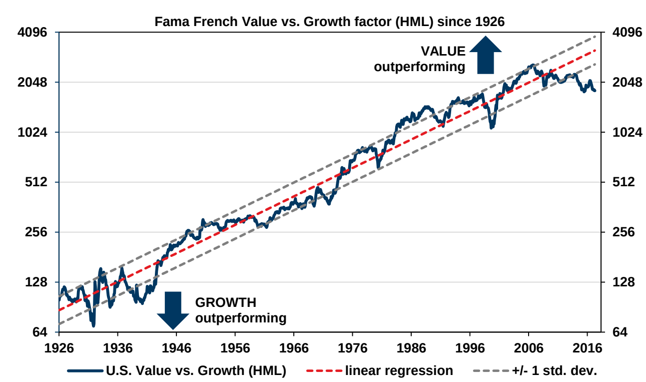
15 Value appears increasingly cheap relative to growth



Source: AQR