NATIONAL BANK

ASSET ALLOCATION STRATEGY

July 3, 2018

2018 Half Complete: Half Empty or Half Full?

Highlights

- Trade tensions between the U.S. and virtually all of its trade partners have escalated quite significantly over the last few weeks. Foreseeing President Trump game plan on trade is no easy feat, but with few signs that the White House has any intention of backing off in the near term, we've decided to add another notch of caution to our allocation by slightly increasing our bond position on June 19.
- Notwithstanding political jitters, the fundamental reason underlying the cautious stance we adopted earlier this year lies in the state and age of the business cycle. Over the last six months, monetary conditions have undeniably tightened, while global growth appears to be shifting down a gear, but a recession signal is still pending. In other words, it's getting late in the business cycle – a period where risk assets should continue to outperform, but a more prudent approach to risk-taking must be reinforced.
- Unless crude oil continues on its stellar performance and inflation reaches a point where the BoC is compelled to act more forcefully, we expect Mr. Poloz will use a very cautious approach which will limit the appreciation potential of the Loonie, especially when waters remain murky regarding a trade deal.
- We think the oil Cartel played their cards masterfully since the cuts were announced in November 2016 and, consequently, we anticipate crude prices will continue to appreciate by year-end.
- For the bond market, we expect the current phase of consolidation to continue until more clarity on the trade issues is provided. With U.S. 10-year treasury yields only inches from those of 30-year maturities, we continue to recommend a slightly short-duration strategy aiming at the belly of the curve.
- For equities, we decided to adjust our tactical positioning on June 19, augmenting U.S. equities from neutral to overweight and reverting back to neutral on emerging markets (EM). We've also taken some profits in our Canadian stocks position in light of their remarkable catch-up, but are sticking to our overweight stance.
- We acknowledge that the S&P 500 is far from immune from a trade war, but the benchmark should continue to benefit from an ever-surprising U.S. economic momentum, while most of the tech heavyweights are less exposed to potential tariffs.
- We continue to like EM from a strategic standpoint, but the lack of clarity on the trade front is simply incompatible with an overweight stance short-term wise.

Table 1 **Global Asset Allocation**

Global Classes	−		Weights		+
Cash			Current		
Fixed Income		Current			
Equities				Current	
Fixed Income					
Federal		Current			
Investment Grade			Current		
High Yield (USD)			Current		
Non-Traditional FI				Current	
World Equities					
S&P/TSX				Current	
S&P 500 (USD)			Previous	Current	
MSCI EAFE (USD)	Current				
MSCI EM (USD)			Current	Previous	
Factors and Alternative Investments					
Value vs. Growth			Current		
Small vs. Large			Current		
Low Vol. vs. High Beta		Current			
Canadian Dollar			Current	Previous	
Commodities				Current	
Energy				Current	
Base Metals				Current	
Gold			Current		
Infrastructure			Current		

Source: CIO Office

Current Allocation
Previous Allocation

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Market Review

Fixed Income

- The Federal Reserve hiked its benchmark rate for the second time this year and the 7th in this cycle, citing strong labour market conditions and inflation nearing their symmetric 2% objective.
- Meanwhile, U.S. 10-year rates finished the month little changed, contained by investors' growing appetite for safer assets in light of rising global trade uncertainties.
- For their part, Canadian long-term rates have edged lower in June, although the Bank of Canada Governor's remarks later in the month have reversed their downward trend, with odds of a July rate hike increasing.

Canadian Equities

- Despite rising trade tensions, the S&P/TSX managed to post modest gains last month, even setting a record high on June 22.
- That brings Canadian equities up 1.9% halfway in 2018, with technology, industrials, real estate, and energy names leading the pack, while defensive sectors such as utilities and telecom got left behind.

U.S. Equities

- The S&P 500 also closed June marginally positive, passing along a bumpy road riddled with tit-for-tat tariff disputes between the U.S. and virtually all of its trade partners.
- Year-to-date, U.S. equities have returned a meager 2.6%, a performance that certainly looks better when converted to Canadian dollars (7.8%).
- Sector divergence is quite spectacular, with Technology (10.9% YTD) and Consumer Discretionary (11.5%) at the positive end of the spectrum, compared to significant losses for Staples (-8.5%) and Telecom names (-8.4%).

Commodities

- Oil kept marching higher last month, with WTI prices jumping to a four-year high following the OPEC+Russia agreement to modestly increase output and the significant inventory draw south of the border.

Foreign Exchange

- It was a tough month for the Loonie, falling to a one-year low as it got caught in a perfect storm of rising trade-related uncertainty and weaker than expected economic data. Still, the currency recouped some of the ground lost in the last few days of June, bolstered by oil prices and rising prospects of a July rate hike by the Bank of Canada.
- Six months into 2018, the Loonie is down 4.4% against the Greenback.

Table 2 **Market Returns**

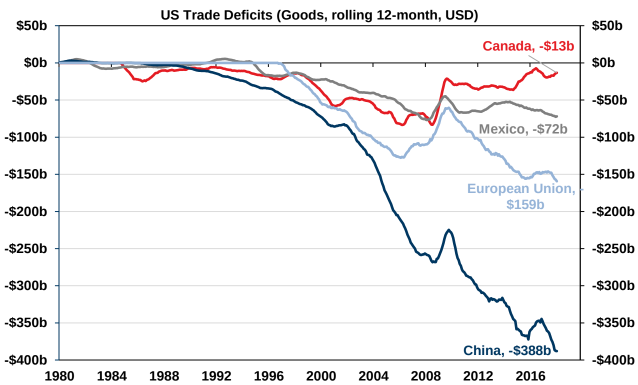
Asset classes	June	Q2	YTD
Cash (3-month T-bills)	0.1%	0.3%	0.6%
Bonds (FTSE/TMX Ovr. Univ.)	**0.6%**	**0.5%**	**0.6%**
FTSE/TMX Short term	0.2%	0.3%	0.5%
FTSE/TMX Mid term	0.7%	0.2%	0.3%
FTSE/TMX Long term	1.0%	0.9%	0.9%
FTSE/TMX Government	0.6%	0.6%	0.6%
Federal	0.5%	0.3%	0.7%
Provincial	0.8%	0.8%	0.5%
Municipal	0.7%	0.6%	0.6%
FTSE/TMX Corporate	0.4%	0.4%	0.7%
AA+	0.3%	0.2%	0.4%
A	0.4%	0.4%	0.6%
BBB	0.4%	0.5%	0.9%
BoAML High-Yield (USD)	0.3%	1.0%	0.1%
Preferred Shares	0.3%	0.8%	0.7%
Canadian Equities (S&P/TSX)	**1.7%**	**6.8%**	**1.9%**
Energy	5.4%	15.8%	4.8%
Industrials	-0.4%	9.4%	6.6%
Financials	0.1%	2.1%	-1.5%
Materials	1.8%	7.9%	3.3%
Utilities	2.5%	-0.4%	-6.2%
Cons. Disc	0.7%	6.6%	3.5%
Cons. Staples	3.2%	3.5%	-2.6%
Healthcare	6.0%	14.3%	-1.1%
IT	0.5%	10.9%	22.2%
Telecom	1.7%	1.9%	-5.0%
REITs	1.7%	4.7%	5.3%
S&P/TSX Small Cap	-0.3%	6.6%	-1.7%
US Equities (S&P500 USD)	**0.6%**	**3.4%**	**2.6%**
Energy	0.7%	13.5%	6.8%
Industrials	-3.3%	-3.2%	-4.7%
Financials	-1.9%	-3.2%	-4.1%
Materials	0.3%	2.6%	-3.1%
Utilities	2.8%	3.7%	0.3%
Cons. Disc	3.6%	8.2%	11.5%
Cons. Staples	4.5%	-1.5%	-8.5%
Healthcare	1.6%	3.1%	1.8%
IT	-0.4%	7.1%	10.9%
Telecom	2.4%	-0.9%	-8.4%
REITs	4.4%	6.1%	0.8%
Russell 2000 (USD)	0.6%	7.4%	7.0%
World eq. (MSCI ACWI)	**-0.5%**	**0.7%**	**-0.1%**
MSCI EAFE (USD)	-1.2%	-1.0%	-2.4%
MSCI EM (USD)	-4.1%	-7.9%	-6.5%
Commodities (CRB index)	**-1.6%**	**0.5%**	**1.5%**
WTI Oil (US$/barrel)	10.7%	14.3%	22.6%
Gold (US$/ounce)	-4.1%	-5.5%	-4.0%
Copper (US$/tonne)	-3.2%	-0.8%	-8.1%
Forex (DXY - US Dollar index)	**0.7%**	**5.0%**	**2.7%**
USD per EUR	0.0%	-5.1%	-2.8%
CAD per USD	1.3%	1.8%	4.4%

Source: Datastream 6/29/2018

Prudence Is the Motto

Trade tensions between the U.S. and virtually all of its trade partners have escalated quite significantly over the last few weeks, with the Trump administration using a risky combination of tariff threats and belligerent rhetoric to put pressure on nations running a significant trade surplus with America (**Chart 1**).

1 Mounting pressure on key U.S. trade partners



Source: Datastream, U.S. Census Bureau

The President's *America First* agenda was widely expected to ramp up just in time for November's midterm elections, being one of the key pillars of his 2016 campaign. However, Trump has surprised with his aggressiveness lately, and particularly harsh comments from Chinese President have dashed hopes the world's two superpowers would settle by July 6 – the deadline set by the White House after which tariffs on $34 billion of Chinese goods will come into force.

In the West you have the notion that if somebody hits you on the left cheek, you turn the other cheek, […] in our culture we punch back.

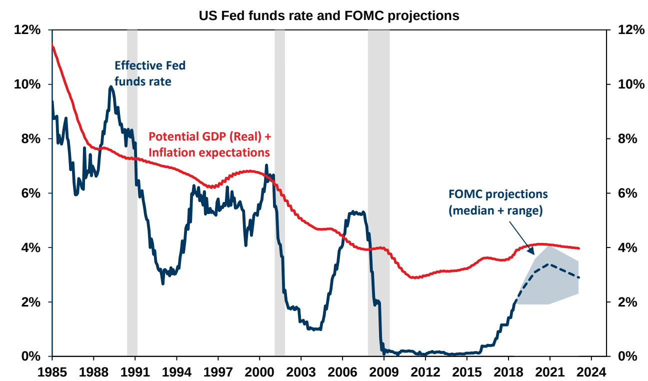
- Xi Jinping speaking to the Global CEO Council on June 25, as reported by the Wall Street Journal.

Foreseeing President Trump game plan on trade is no easy feat, but with few signs that the White House has any intention of backing off in the near term, we've decided to add another notch of caution to our allocation by slightly increasing our bond position on June 19.

Notwithstanding political jitters, the fundamental reason underlying the cautious stance we adopted earlier this year lies in the state and age of the business cycle. With half of 2018 now behind us, we thought time was prone to step back from the daily political drama and focus on how the global economic backdrop has evolved over the last six months.

From a monetary policy standpoint, conditions have undeniably tightened globally, largely on the back of the Federal Reserve's pace of one rate hike per quarter (one in March, one in June), and signal it intends to stay on that track for the rest of the year (**Chart 2**).

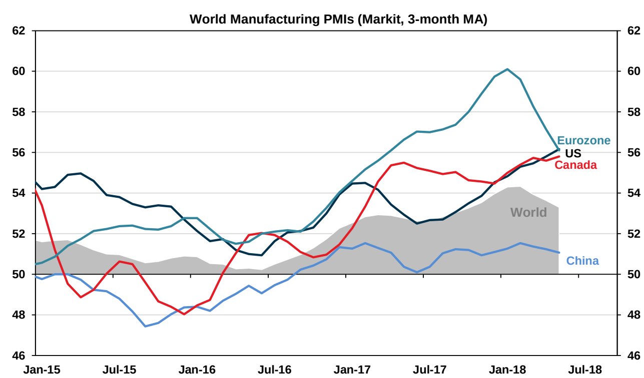
2 Monetary conditions set to keep tightening



Source: Datastream

The Fed has all the reasons in the world to keep moving its policy from accommodative to neutral, faced with a local economy running above potential and inflation nearing its symmetric 2% target. However, the same cannot be said of other countries, with global manufacturing PMIs showing the return of cyclical divergence following 2017's "global synchronized upswing" (**Chart 3**).

3 Synchronized growth is no longer the order of the day

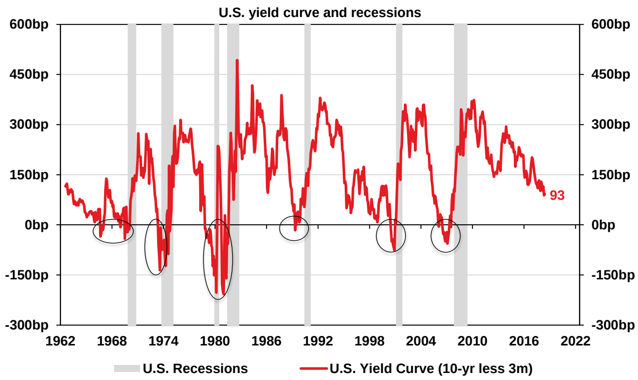


Source: Datastream

The world economy might be shifting down a gear, but it remains well anchored in growth territory. And, with the slope of the yield curve at close to 100 basis points, a recession signal is still pending (**Chart 4**, next page).

So what's to make of this context of rising geopolitical uncertainty, tighter monetary conditions, and slower global economic momentum albeit with little recession risk on the horizon? We believe this simply reflects the fact that it's getting late in the business cycle – a period where risk assets should

4 A recession signal is still pending



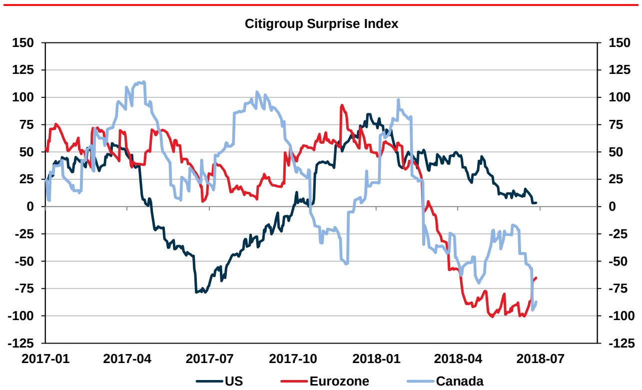
Source: Datastream

continue to outperform, but a more prudent approach to risk-taking must be reinforced.

Currencies: Monetary Policy Divergence is Back

As we stated in the previous section, synchronized global growth started to fade away in the first half of 2018, and so did the U.S. dollar's weakness with monetary policy divergence between the Fed and the other central banks making a comeback. Looking at economic surprises, the U.S. is the only region to have met expectations since the beginning of the year while other countries are faltering (**Chart 5**). In light of this, the FOMC seems undeterred in following the pre-set course of hikes in 2018 while doubt is seeping into other central bankers' minds regarding their own strategy.

5 US are meeting expectations. The others? Not so much

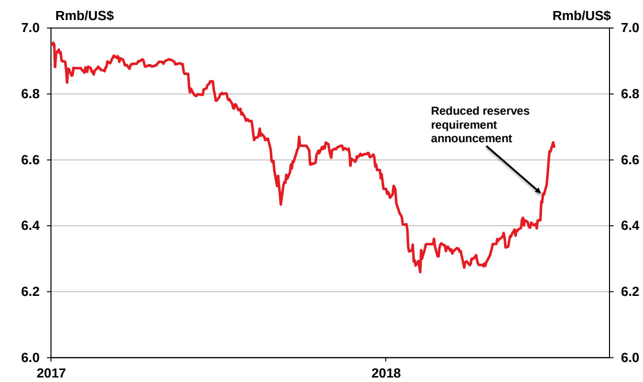


Source: Datastream

A large part of what's in line for the Greenback in the coming months depends on how and when countries resolve their trade issues. The rise of protectionism is a natural tailwind for the U.S. dollar, as it not only spurs flight-to-safety flows from foreign investors but also impacts foreign monetary policy as central banks need to weigh-in the potential impact of tariffs on their respective countries.

As of now, the strength of U.S. domestic growth helps to isolate it from any adverse effect regarding those tariffs while some of its partners are forced to react. Case in point: the PBOC's recent decision to reduce reserve requirements by $100 billion which will act as a way to stimulate economic activity, but also reduce the potential impact of a trade war. Of course, such a decision depreciates the Yuan (**Chart 6**), which also helps Chinese exports become more competitive on the world stage. However, the currency is prone to extreme movements and, in light of the recent weakness, the PBOC reassured the markets by citing its strong domestic economy to prevent capital outflows.

6 The PBOC helps Chinese exporters remain competitive



Source: Datastream

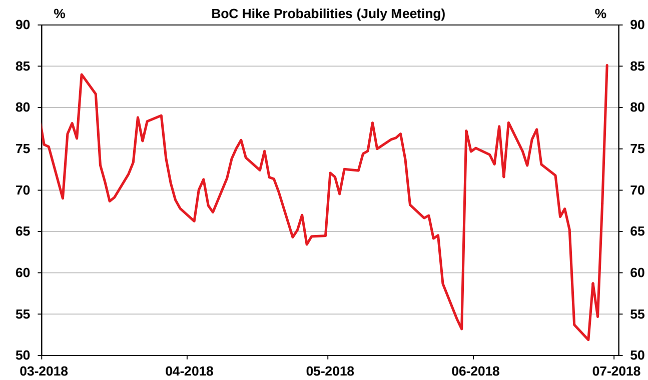
In conclusion, while we expect economic sense will ultimately prevail on the trade front, until we witness some easing of tensions or a pick-up in economic growth globally, the path of least resistance will be up for the Greenback.

The Loonie is also suffering from its southern neighbour's wrath. While we expected cooler heads would prevail regarding NAFTA negotiations a couple of quarters ago, the reverse is happening as the U.S. administration has become more and more aggressive in its rhetoric regarding Canada, pushing further away the potential for a resolution on a NAFTA-2 deal. Of course, this has an impact on the BoC's plan for future hikes and, in a speech on June 27, Mr. Poloz confirmed this issue will be considered when setting monetary policy:

> *"Today, as we approach our next interest rate decision, we are working to incorporate in our projections the effects of the recently announced U.S. steel and aluminum tariffs, along with retaliatory measures, both in Canada and globally. We are also analyzing individual-level data to understand how the new lending guidelines in Canada are affecting the housing market and mortgage renewals. We expect these issues to figure prominently in our upcoming deliberations."*
>
> *- Governor Poloz, June 27, 2018*

To add to recent bad news for the Governor, inflation and retail sales have also disappointed recently which temporarily pushed the possibilities of a hike in July from a certainty to a coin toss. But, the odds rebounded after the BoC published an optimistic Business Outlook Survey and GDP numbers came in a touch above expectations (**Chart 7**).

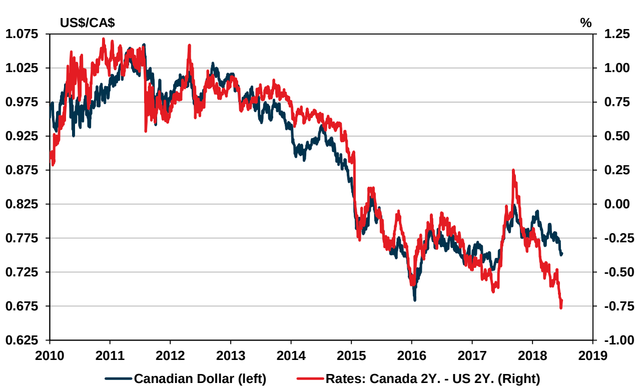
7 BoC is playing yoyo with market expectations



Source: Bloomberg

So what's in line for the rest of the year? Of course, energy prices can act as a support for the currency (see next section), but as we've stated on numerous occasions, the rate differential with the U.S. and monetary policy are much more important in setting the Canadian dollar's value (**Chart 8**).

8 The rate differential still sets the loonie value



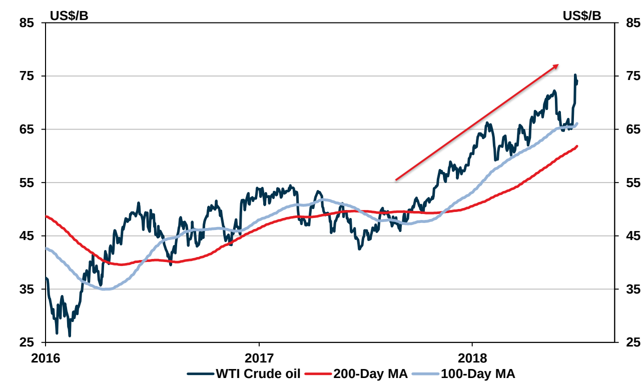
Source: Datastream

Consequently, unless crude oil continues on its stellar performance and inflation reaches a point where the BoC is compelled to act more forcefully, we expect Mr. Poloz will use a very cautious approach which will limit the appreciation potential of the Loonie, especially when waters remain murky regarding a trade deal.

Commodities: OPEC's Iron Grip

For energy markets, the first half of the year was marked as a continuation of the trend set in 2017 (**Chart 9**) as the whole complex bended to OPEC's will. Inventories are now finally below their five-year average, which was the Cartel's objective when cuts were initially announced.

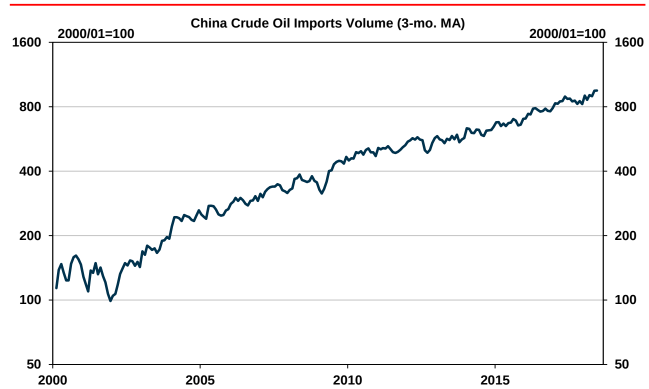
9 2018 is following through on 2017's momentum



Source: Datastream

Saudi Arabia and Russia's exit strategy from the cuts is one of the issues we highlighted at the beginning of the year which could spell the rally's end. In retrospect, these fears were unfounded. The 4% price drop when a 1 million barrel per day increase in production was announced is now offset by unplanned shutdowns in Venezuela, Nigeria, and in Canada (via Syncrude). Despite emerging markets suffering (especially China) in light of a potential trade war, demand for energy products remains undeterred for now (**Chart 10**).

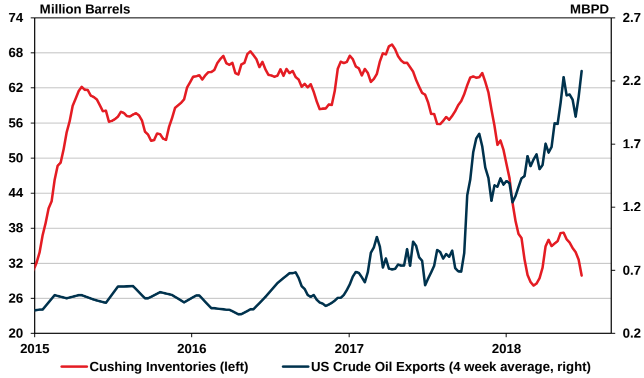
10 China's appetite for crude is constantly increasing…



Source: Datastream

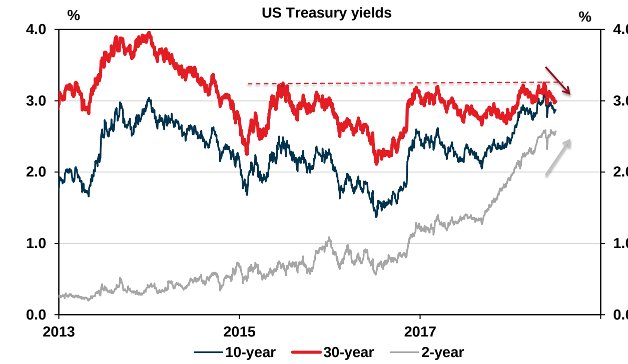
For the second half of 2018, we worry that risks may be skewed to the upside. Venezuelan production is continuously dropping and not showing signs of reversing course and, thanks to increasing exports, U.S. inventories are rapidly decreasing (**Chart 11**, next page).

11 … while U.S. exports are picking up



Source: Datastream

12 Bond market: Not so fast Mr. Powell!



Source: Datastream

Shale oil partially fills in for the shortfall, but pipeline capacity is insufficient to fully translate production from the Permian Basin to world markets. This logistical constraint is expected to last until 2020, which means growth in the area will be less than optimal until then.

President Trump is also pressuring other countries to boycotting Iranian oil, which could reduce supply to a market already in deficit. In light of this, not only is the OPEC ramp-up necessary, but any unforeseen outages in the production complex would need to draw from the Cartel's spare capacity to balance the supply-and-demand picture.

We think the Cartel played their cards masterfully since the cuts were announced in November 2016 and, consequently, we anticipate prices will continue to slowly appreciate by year-end. However, lower inventories usually rhyme with increased volatility and upswings have the potential to be violent, especially if OPEC and Russia are too slow to react to unforeseen production shortfalls, or if they are beyond the Saudi Arabia's ramp-up capabilities.

Fixed Income: What About the Rest of the World?

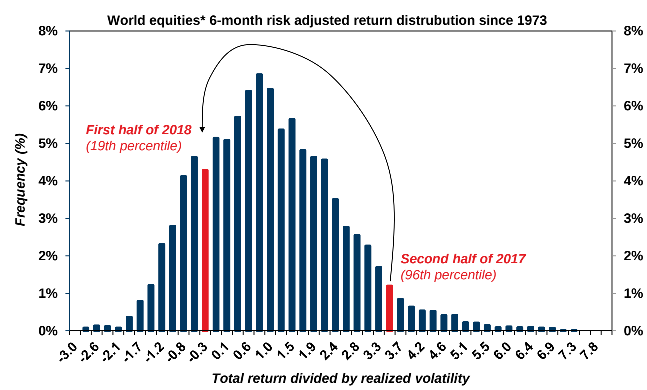
For the bond market, we expect the current phase of consolidation to continue until more clarity on the trade issues is provided. Despite the Fed showing clear intentions of raising key interest rates further in the face of above-potential economic growth, a tight labour market, and inflation picking-up, long-bond yields are having a tough time reaching new highs (**Chart 12**).

This suggests the market doubts the current pace of Fed tightening (one hike per quarter) can be maintained amid trade tensions and a slowdown elsewhere in the world. With U.S. 10-year treasury yields only inches from those of 30-year maturities, we continue to recommend a slightly short-duration strategy aiming at the belly of the curve.

Equities: The Power of Mean Reversion

Pushing the pause button and looking at the main trends of the last six months of market action shows how strong mean reversion can be. For instance, global equities' return to volatility ratio (total return divided by realized volatility over a given period) went from the far right of the distribution in H2-2017 (96th percentile) all the way to the left (19th percentile) in H1-2018 (**Chart 13**). In other words, the stock market has yielded somewhat poor returns halfway into 2018, while volatility climbed closer to its average.

13 Mean reversion in risk adjusted equity returns…

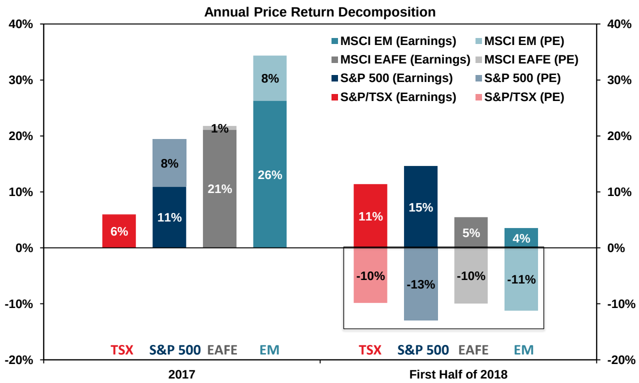


Source: Datastream, World market (DS reconstructed index)

What's more, those disappointing YTD performances are primarily a consequence of another factor which was due for mean reversion: valuation multiples. Indeed, while forward earnings showed decent growth, in most cases, those gains have been more than offset by a compression in PE ratios (**Chart 14**, next page).

Back in May, we stated that "*To put it simply, higher rates imply that investors are less willing to pay high multiples for equities. Hence, the growing importance of corporate earnings as drivers of equity returns.*" Since then, the combination of a

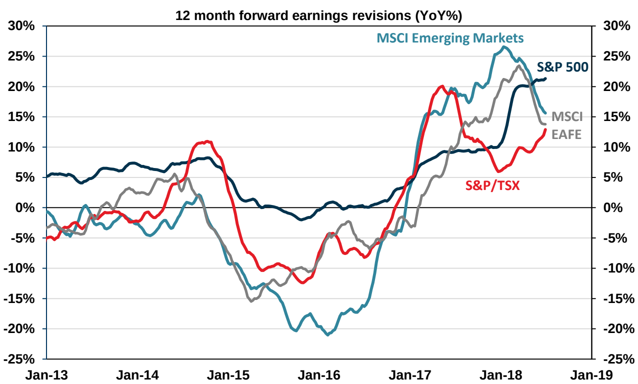
14 … driven by a mean reversion in PE ratios



Source: Datastream

deterioration in market sentiment stemming from the rising prospect of a global trade war and the de-synchronization of global growth appears to have most affected emerging markets and EAFE equities, as North American indices earnings expectations haven't flinched (**Chart 15**).

15 North American earnings expectations haven't flinched



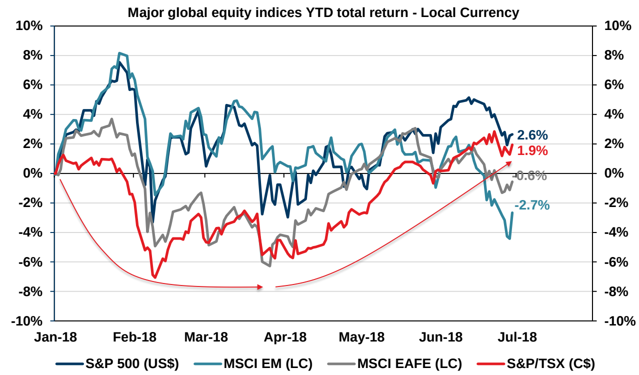
Source: Datastream

Under these circumstances, we decided to adjust our tactical positioning on June 19, augmenting U.S. equities from neutral to overweight and reverting back to neutral on emerging markets (EM). We've also taken some profits in our Canadian stocks position, but are sticking to our overweight stance.

The catch-up orchestrated by the S&P/TSX since we re-engaged with an overweight recommendation late in March is quite remarkable, passing from heavy laggard in Q1 to top performer in Q2, thanks to rising crude oil prices and a weaker Loonie tailwind on foreign earnings expectations (**Chart 16**).

We continue to believe in their capacity to outperform given their sector allocation is better suited to a late-cycle environment. However, considering the speed at which they

16 Remarkable catch-up by the S&P/TSX in Q2

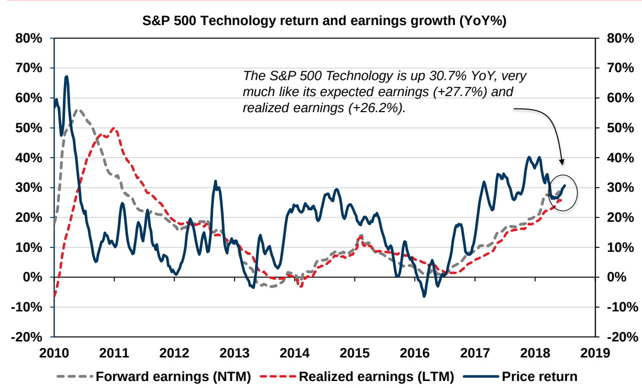


Source: Datastream

rebounded in spite of the U.S.-Canada trade dispute still being very much alive, some profit-taking was warranted in our view.

As for U.S. equities, we acknowledge they are far from immune from a trade war, with 43% of S&P 500 sales generated abroad. However, the balance should continue to benefit from an ever-surprising U.S. economic momentum, while most of the tech heavyweights are less exposed to potential tariffs and, most importantly, keep on growing on the back of stellar earnings growth, not on ratio expansion (**Chart 17**).

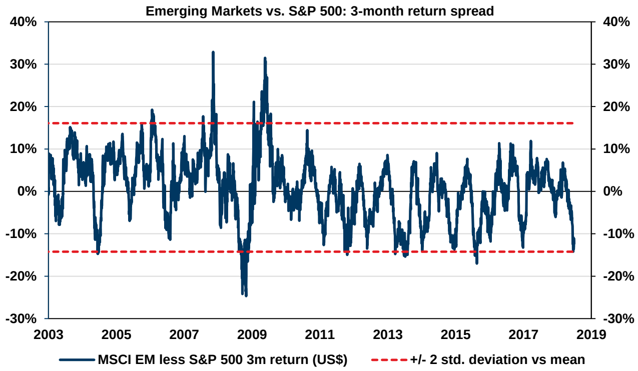
17 Technology outperformance driven by earnings



Source: Datastream

Finally, EM have suffered quite extensively over the last few weeks, with the trade war scenario unfolding before us – one of the two key risks mentioned in our March 2018 Strategic Report *Grown Up Emerging Markets*. We continue to like the region from a strategic standpoint, but the lack of clarity on the trade front is simply incompatible with an overweight stance short-term wise. Therefore, we revert back to neutral, but could quickly reassess this positioning should the situation become clearer. After all, if it were up to mean reversion, one could easily argue that the EM selloff is overdone and set to reverse (**Chart 18**, next page).

18 **Mean reversion ahead?**



Source: Datastream