NATIONAL BANK

ASSET ALLOCATION STRATEGY

June 1, 2018

Back to Cautious Optimism

Highlights

- The premise of our first Asset Allocation Strategy report of the year was *Cautiously Optimistic in 2018*. Following mid-February market correction, we were inclined to opportunistically add risk and buy the dip. Almost three months later, global equities have recovered, but not to the extent that we expected following a stellar Q1 earnings season.
- With earnings now in the rear-view mirror, the constant rise in geopolitical risk in an aging business cycle has prompted us to trim risk and reduce our equity allocation a notch on May 29.
- To be clear, we continue to think that equities have good quarters ahead of them, hence why our allocation remains tilted in favour of risk assets. Leading economic indicators still point higher, and the pace of inflation remains well contained, leaving room for global central banks to slowly normalize their monetary policies.
- We also took the opportunity to adjust our geographical mix, sticking to our S&P/TSX and emerging markets (EM) overweight stance, but funding it through a maximum underweight in EAFE equities rather than U.S. stocks.
- From a risk standpoint, we continue to like being simultaneously overweight on emerging markets (EM) and Canadian equities, a complementary mix that has indeed lived up to its name recently.
- The growth gap between EAFE equities and the rest of the world has significantly widened over the last few weeks, supporting the case for a reduction in our allocation to the region.
- On the flip side, S&P 500 profits continue to enjoy the relentless growth coming out of the technology sector, with the five tech giants alone strong enough to bring the index in positive territory YTD and ahead of the S&P/TSX, a trend that is simply unwise to fight, in our view.
- While the greenback is benefitting from recent economic and geopolitical tailwinds, we must remember that the FOMC will not get ahead of itself and start hiking much faster than what was expected a couple of months ago.
- We remain favorable to our allocation with respect to the Canadian dollar, but with a weaker conviction than the last couple of months with NAFTA negotiations still looming large and the timeframe for resolution is constantly being pushed back.
- In a way, OPEC took on the mantle of an energy central banker whose mandate is to reduce crude's volatility. Now they are managing an orderly appreciation in value and as long as the cartel has some spare capacity, they should be able to reign in runaway moves. Consequently, we expect they will achieve their objective and help prices to slowly increase by year-end.

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

- U.S. 10-year Treasury yields initially received a boost from strong economic data, reaching a fresh 7-year high of 3.12% on May 18, but completely reversed course in the second half of the month, following dovish FED minutes and Italy's political jitters.
- Canadian 10-year rates also backed off late in May, as the Bank of Canada left its policy rate unchanged at 1.25% and opened the door for a July rate hike in the face of robust economic activity and accelerating inflation.

Canadian Equities

- The S&P/TSX delivered its best monthly performance in nearly two years (July 2016), supported by rising commodity prices and outpacing all major foreign equity indices.
- Gains were particularly strong in the Healthcare, Technology, Industrials, Materials, and Consumer Discretionary sectors, while Utilities and Telecom lagged.

U.S. Equities

- U.S. equities closed the month in positive territory and volatility remained well contained for the most part, supported by a stellar Q1-2018 earnings season and robust economic indicators.

Commodities

- Crude oil prices have been stirred up in both directions through the month, initially pushed higher by Trump's decision to pull the U.S. out of the Iran nuclear deal, and latter dragged down by rumours surrounding OPEC's intention to increase supply.

Foreign exchange

- This is the second consecutive strong month for the greenback, having gained more than 7% against the euro since its February trough, as growth differentials started turning in the U.S.'s favour and Italy's political crisis escalated.
- For its part, the loonie closed the period marginally weaker after the confirmation that the U.S. would follow through with its threat to impose tariffs on Canadian steel and aluminum. This announcement cancelled the positive effects of the BoC's upbeat comments on inflation and growth.

Table 2 Market Returns

Asset classes	May	YTD	2017
Cash (3-month T-bills)	0.1%	0.5%	0.6%
Bonds (FTSE/TMX Ovr. Univ.)	**0.8%**	**0.0%**	**2.5%**
FTSE/TMX Short term	0.2%	0.3%	0.1%
FTSE/TMX Mid term	0.4%	-0.4%	1.0%
FTSE/TMX Long term	2.0%	-0.1%	7.0%
FTSE/TMX Government	0.9%	0.0%	2.2%
Federal	0.6%	0.2%	0.1%
Provincial	1.2%	-0.3%	4.3%
Municipal	1.0%	-0.2%	4.7%
FTSE/TMX Corporate	0.6%	0.3%	3.4%
AA+	0.1%	0.1%	0.7%
A	0.7%	0.2%	4.4%
BBB	0.6%	0.5%	4.0%
BoAML High-Yield (USD)	0.0%	-0.3%	7.5%
Preferred Shares	1.0%	0.4%	13.6%
Canadian Equities (S&P/TSX)	**3.1%**	**0.2%**	**9.1%**
Energy	2.8%	-0.5%	-7.0%
Industrials	6.8%	7.0%	19.7%
Financials	1.4%	-1.6%	13.3%
Materials	5.6%	1.4%	7.7%
Utilities	-1.2%	-8.5%	10.8%
Cons. Disc	4.7%	2.9%	22.8%
Cons. Staples	1.6%	-5.7%	7.8%
Healthcare	11.9%	-6.7%	34.2%
IT	7.8%	21.6%	16.8%
Telecom	-0.6%	-6.6%	14.8%
REITs	3.3%	3.6%	11.2%
S&P/TSX Small Cap	1.8%	-1.4%	2.8%
US Equities (S&P500 USD)	**2.4%**	**2.0%**	**21.8%**
Energy	3.0%	6.1%	-1.0%
Industrials	3.0%	-1.4%	21.0%
Financials	-0.9%	-2.2%	22.2%
Materials	2.1%	-3.4%	23.8%
Utilities	-1.1%	-2.4%	12.1%
Cons. Disc	2.0%	7.6%	23.0%
Cons. Staples	-1.5%	-12.5%	13.5%
Healthcare	0.2%	0.2%	22.1%
IT	7.4%	11.3%	38.8%
Telecom	-2.3%	-10.5%	-1.3%
REITs	2.3%	-3.5%	10.8%
Russell 2000 (USD)	5.9%	6.4%	13.1%
World eq. (MSCI ACWI)	**0.2%**	**0.4%**	**24.6%**
MSCI EAFE (USD)	-2.1%	-1.2%	25.6%
MSCI EM (USD)	-3.5%	-2.5%	37.8%
Commodities (CRB index)	**0.2%**	**3.2%**	**2.2%**
WTI Oil (US$/barrel)	-2.3%	10.8%	12.5%
Gold (US$/ounce)	-0.7%	0.0%	12.6%
Copper (US$/tonne)	1.1%	-5.0%	30.5%
Forex (DXY - US Dollar index)	**2.3%**	**2.0%**	**-9.9%**
USD per EUR	-3.4%	-2.8%	13.8%
CAD per USD	0.9%	3.0%	-6.4%

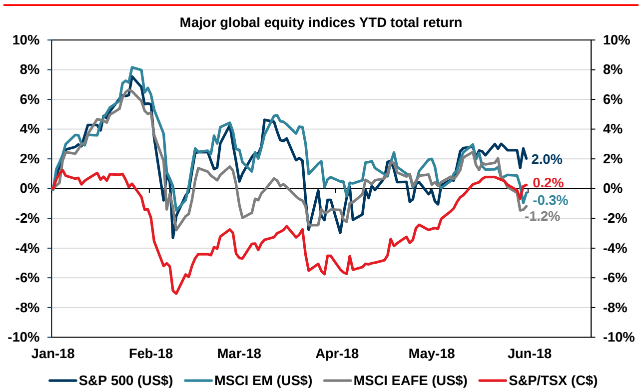
Source: Datastream 5/31/2018

Back to Cautious Optimism

In our first Asset Allocation Strategy report of 2018, we stated that: "*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*." … Hence our title: *Cautiously Optimistic for 2018*.

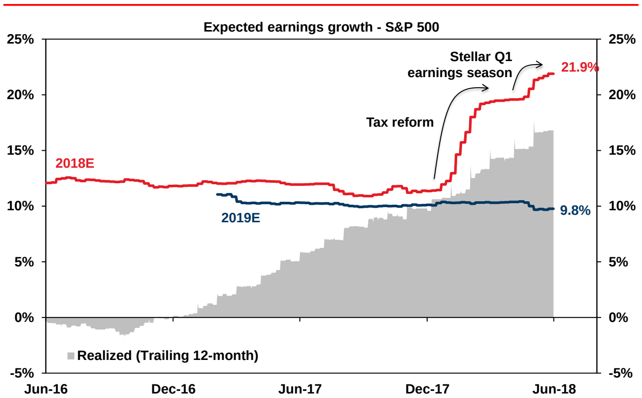
With the mid-February market correction, we were inclined to opportunistically add risk and buy the dip in light of what we perceived as exaggerated inflation fears and temporary effects coming from the wind-down of products tied to volatility. Almost three months later, global equities have recovered (**chart 1**), but not to the extent that we expected following a stellar Q1 earnings season (**chart 2**).

1 Equities recovered from February's correction…



Source: Datastream

2 … but not as much as we expected given such earnings

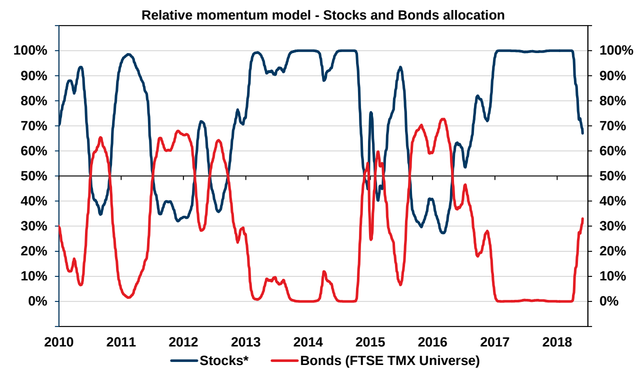


Source: Datastream

With earnings now in the rear-view mirror, the constant rise in geopolitical risk in an aging business cycle has prompted us to trim risk and reduce our equity allocation a notch on May 29.

This move was also supported by our Relative Momentum Model, which started calling for an increase in bonds early in April, following close to one-and-a-half years of sticking to its maximum equity weight (**chart 3**). In other words, recent market action suggests that the equity market dominance over bonds has started running out of steam, and therefore called for some de-risking.

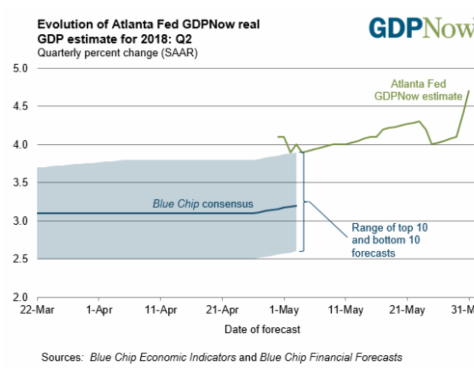
3 Relative momentum calls for some de-risking…



Source: Datastream. *S&P/TSX, S&P 500, MSCI EM and MSCI EAFE. Illustrates the recommended allocation against a benchmark of 50% equities, 50% bonds.

To be clear, we continue to think that equities have good quarters ahead of them, hence why our allocation remains tilted in favour of risk assets. Leading economic indicators still point higher, especially in the U.S. where the Atlanta FED *GDPNow* tracker is suggesting 4.7% growth in Q2 (**chart 4**), and the pace of inflation remains well contained, leaving room for global central banks to slowly normalize their monetary policies.

4 … while the backdrop remains supportive of risk assets



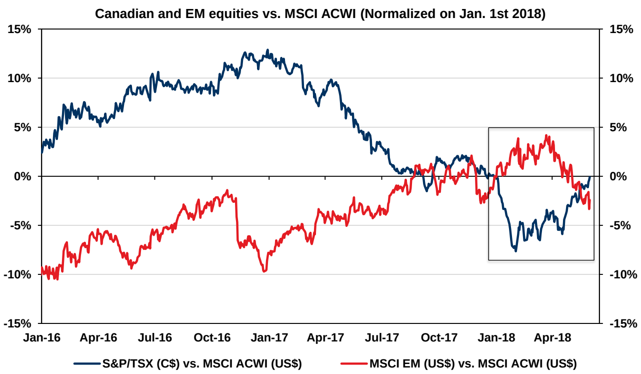
Source: Atlanta Fed

Equities: Driven by Currencies

As we reduced our total equity allocation, we took the opportunity to adjust our geographical mix, sticking to our S&P/TSX and emerging markets (EM) overweight stance, but funding it through a maximum underweight in EAFE equities rather than U.S. stocks.

From a risk standpoint, we continue to like being simultaneously overweight on emerging markets (EM) and Canadian equities, a complementary mix that has indeed lived up to its name recently (**Chart 5**).

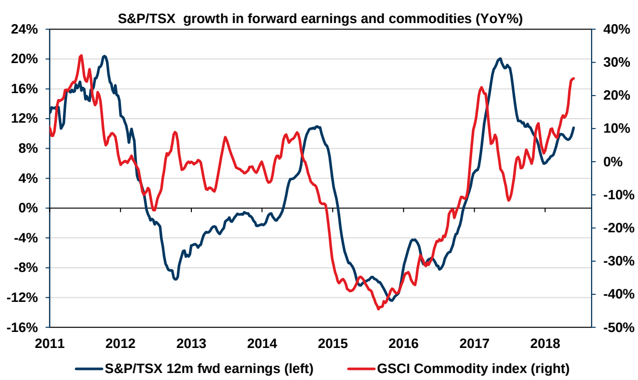
5 Canada taking off… Emerging markets loose their lead



Source: Datastream.

For now, Canada is standing out as a winner, supported by rising commodity prices and subsequent positive earnings revisions (**chart 6**), and we expect this trend to persist (see Commodities section).

6 S&P/TSX forward earnings lifted by commodity prices

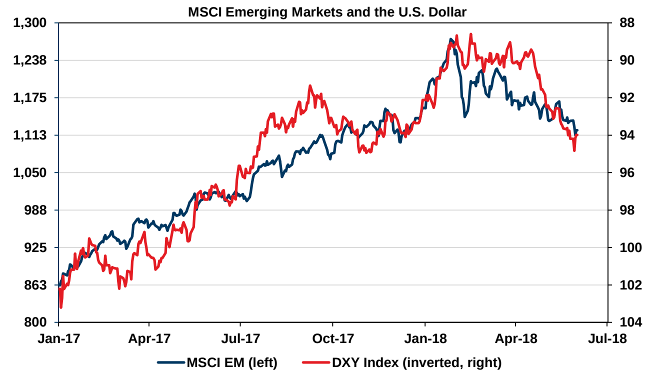


Source: Datastream.

For their part, EM assets have continued to be impeded by a resurgent U.S. dollar. Although stronger macroeconomics and credit fundamentals than seen 20 years ago limit greatly the risks of a full-blown EM crisis, a stronger greenback undeniably makes it hard for them to reach new highs (**chart 7**).

Our base case scenario remains one of a slow and steady rise of U.S. Treasury yields, together with strong global growth and a U.S. dollar back on its secular downtrend – an environment in which both EM and Canadian equities should outperform their peers.

7 EM equities impeded by a resurgent U.S. dollar



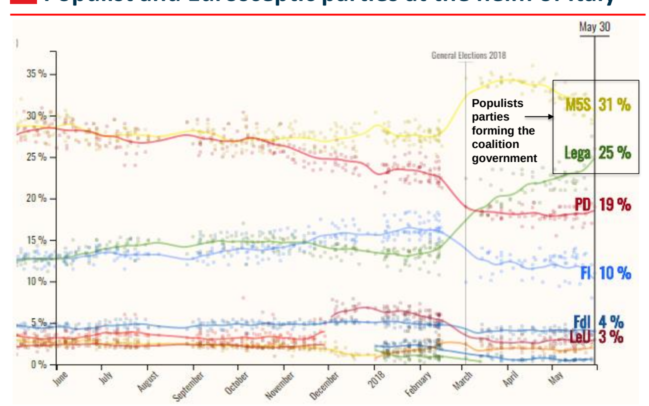
Source: Datastream.

Still, we acknowledge the probability that the one-and-a-half-month-old dollar rally could extend further (see Currencies section), and that is partly why we swapped our funding from being underweight on U.S. equities to being underweight on EAFE.

For instance, euro weakness appears to be the main culprit behind the recent dollar strength, a reflection of the widening growth differential between the regions, but also of the rising political uncertainty "made in Italy".

Recent episodes of geopolitical upheaval (Greece's experiment in populism, Trump's election, Brexit, and North Korean hazards) have demonstrated that they generally finish with more fear than harm. As a matter of fact, a new coalition government was quickly agreed on, soothing the fears of another election and leading Italian assets to recover most of the losses. Still, with two populist/Eurosceptic parties now in charge of Eurozone's third-largest economy and an increasing share of the population behind them (**chart 8**), risks are clearly to the downside.

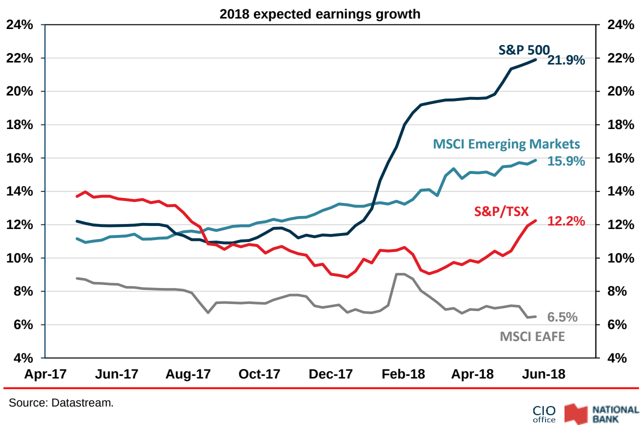
8 Populist and Eurosceptic parties at the helm of Italy



Source: Polls of polls (https://pollofpolls.eu/IT)

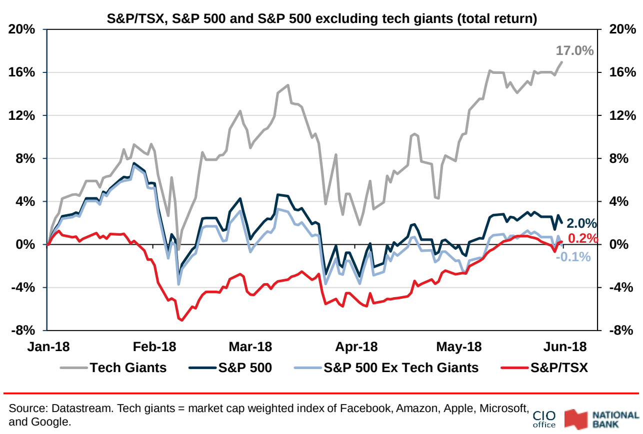
Beyond political jitters, and perhaps most importantly, the growth gap between EAFE equities and the rest of the world has significantly widened over the last few weeks (**chart 9**), supporting the case for a reduction in our allocation to the region.

9 The gap between EAFE and the world is widening



On the flip side, S&P 500 profits continue to enjoy the relentless growth coming out of the technology sector, with the five tech giants alone strong enough to bring the index in positive territory YTD and ahead of the S&P/TSX (**Chart 10**), a trend that is simply unwise to fight, in our view.

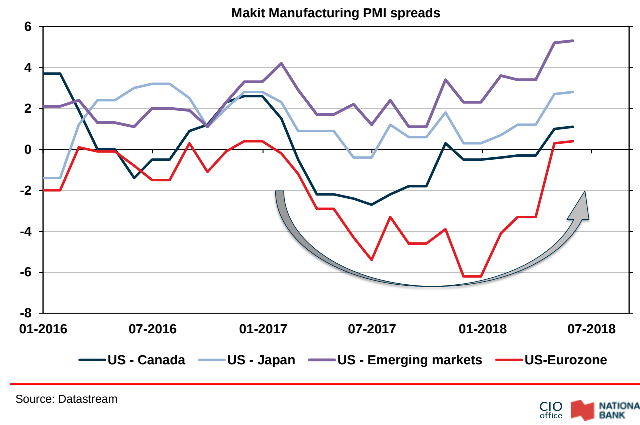
10 The S&P 500 must thank its five technology giants!



Currencies: Political Risks Back in the Spotlight

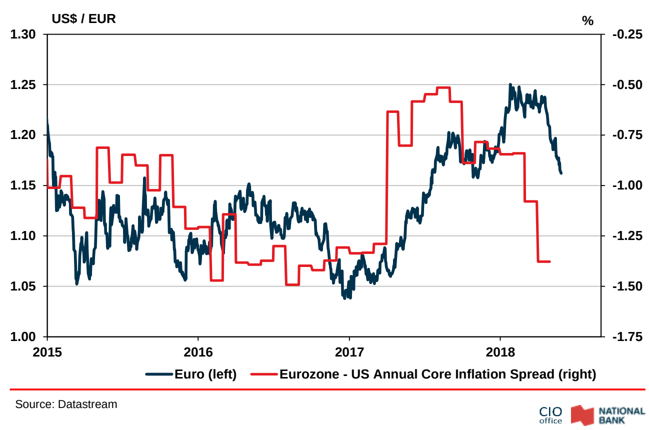
The recent flight to quality flows certainly helped the greenback's appreciation in May, but momentum was already positive before Italy made the headlines. Synchronized global economic growth, which was 2017's main theme, is losing steam this year and signs are pointing towards the U.S. getting ahead of the pack, which naturally translates into an uptick for the U.S. dollar (**chart 11**).

11 US economic growth is breaking away from the pack



Naturally, economic activity also impacts inflation, which is edging lower in the Eurozone in tandem with the value of its currency, as monetary policy divergence between the ECB and the Fed is once again on the radar (**chart 12**).

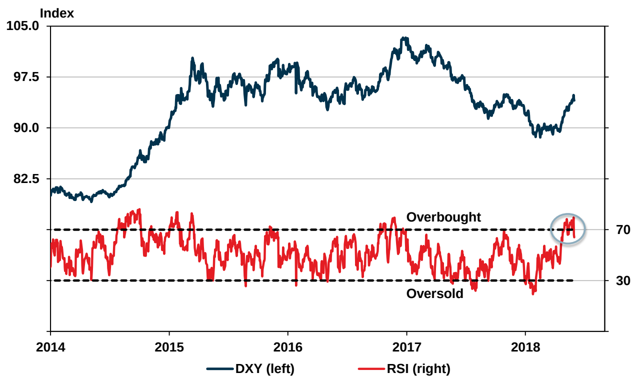
12 Inflation => Monetary policy => Currency value



However, while the greenback is benefitting from recent tailwinds, we must remember that the FOMC will not get ahead of itself and start hiking much faster than what was expected a couple of months ago. The fact that the Central Bank introduced the word "symmetric" when referring to its inflation objective can be interpreted as somewhat dovish. This strategy gives it some leeway should core CPIs come in higher than expected. Additionally, the DXY price action seems technically overstretched (**chart 13**, next page): a consolidation is possible in the next few weeks.

For the loonie, monetary policy divergence with the U.S. is less of an issue as the BoC is also in tightening mode. After a soft patch of economic figures in Canada, the recent statement following the May 30 interest rate decision opened the door for a hike in July, citing higher Q1 economic growth than initially projected, thanks to exports and investments. Market

13 The US dollar is due for a pause



Source: Datastream

expectations now seem in line with our economic department's views which call for two rate increases before the end of the year.

Although we still believe the currency will appreciate by year end, we are well aware that some forces are dragging it down. NAFTA negotiations are still looming large and the timeframe for resolution is constantly being pushed back. While a signed agreement would be supportive towards the loonie, we are left to wonder how much of it is already priced in and if the currency would gain much on the news.

Crude oil's recent performance is also a source of worry, despite our view that the effect from the OPEC statement will ultimately prove temporary (more on that subject in the Commodities section). In light of those developments, we remain favorable to our allocation with respect to the Canadian dollar, but with a weaker conviction than the last couple of months.

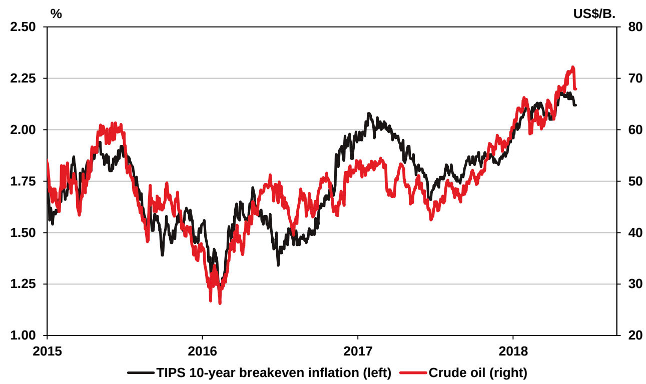
Commodities: OPEC as a Crude Central Banker

On May 25, Saudi Arabia and Russia announced their plan to ease production cuts in the next quarters and, unsurprisingly, oil prices reacted negatively to the news.

This downturn is simply a result of recalibration of world output projections and its impact on the supply-and-demand picture for the next few quarters. Despite some short-term pain, OPEC's decision should only have a very limited impact on the long-term horizon, as an exit strategy from the supply reduction agreement was already in the cards for 2019. In fact, the next few months may prove that the cartel is right to act:

1- Prices are increasing too quickly and OPEC fears that such a surge would hurt global economic growth, which would ultimately translate into reduced demand down the road, especially in emerging markets. Inflation in the U.S. is also strongly impacted by energy levels and a small respite on that front is more than welcome at this stage in the economic cycle (**chart 14**).

14 Lower crude prices keeps a lid on inflation

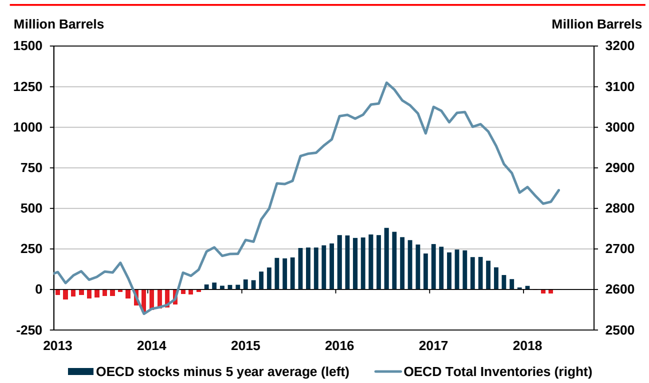


Source: Datastream

2- The supply-and-demand picture is getting increasingly tighter with unplanned reduced output from some members such as Venezuela. The scope of the ramp-up is still unknown, but most agree that the scale will probably be around an additional 1 million barrels per day, which would offset unplanned production shortfalls.

As inventories are getting lower (**chart 15**), the potential for a spike in prices following any additional surprise disruption increases constantly. OPEC needs a way to reduce the pressure on this front, especially when such a scenario could prove costly for Saudi Arabia on the world political stage.

15 OPEC's plan to draw down inventories worked



Source: Datastream

3- This decision may also help the cartel maintain compliance regarding the agreement in the future, as it will certainly please some members who have certain reservations about the initial cuts. It also strengthens the impression that the cartel's coordination with Russia is on solid footing and could last well beyond the end of the deal.

In a way, OPEC took on the mantle of an energy central banker whose mandate is to reduce crude's volatility. The primary goal was to put a floor on prices until the overproduction situation resolved itself and, on that front, they were wildly successful.

Now they are managing an orderly appreciation in value and as long as the cartel has some spare capacity, they should be able to reign in runaway moves. Consequently, we expect they will achieve their objective and help prices to slowly increase by year-end.