NATIONAL BANK

ASSET ALLOCATION STRATEGY

March 1, 2018

Remarkable Comeback

Highlights

- After months of uncanny calm and stability, volatility came back forcefully in February. In our view, this pullback had more to do with a mean reversion to a more sustainable trend.
- Therefore, with (1) macro data suggesting near zero-risk of a recession in the coming quarters, (2) Q4-2017 corporate earnings up double digits, (3) acknowledgement that inflation and volatility were simply getting back toward their average and (4) attractive valuations after stocks fell to the key psychological -10% mark, we decided to tactically augment our equity exposure on February 12, thereby bringing our allocation to 100%.
- In the next few weeks, we will continue to closely monitor levels of complacency or market weakness, and consider some profit-taking given the very tactical nature of this positioning. Still, with an economic backdrop just as strong as before the pullback and rates set on an upward trajectory, we continue to believe stocks will outperform fixed-income assets in 2018.
- As long as rates are pushed higher for "good reasons" – a combination of rising growth prospects, stable inflation and gradual monetary policy/term premium normalization – there's no reason to be concerned.
- In such an environment, we advise staying underweight in government bonds and continue to favour non-traditional unconstrained fixed-income solutions.
- For crude oil, we expect it to trade within the $60 to $70 range. Increased demand from synchronized global growth should help keep prices over the lower threshold while any increase over the upper echelon would be met by a ramp up in U.S. shale oil activity.
- Despite rising in February, our medium-to-long term assumptions for the U.S. dollar remain intact. We still believe it will eventually head lower.
- The loonie future remains unclear for now. We expect it to trade in the 0.77$ and 0.83$ range until we get some form of clarity about NAFTA negotiations, and the gap between WTI and Western Canadian crude oil.
- We remain geographically neutral, but we are considering an overweight position in emerging markets. This will be the subject of a Strategic Report we expect to publish in the coming weeks.

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 ▒

Martin Lefebvre
CIO and Strategist
(514) 412-8572
martin.lefebvre@bnc.ca

Simon-Carl Dunberry
Chief Analyst
(514) 412-8384
simon-carl.dunberry@bnc.ca

Louis Lajoie
Analyst
(514) 412-2054
louis.lajoie@bnc.ca

Market Review

Fixed income

- 10-year U.S. Treasury yields pursued their rise in February, pushed 15 bps higher by rising inflation expectations and an upbeat tone from new Fed Chair Jerome Powell.
- Meanwhile, Canadian rates barely changed as cooling economic growth and uncertainty surrounding NAFTA leads many to believe the Bank of Canada will move cautiously this year.

Canadian equities

- Canada's main stock index initially held up better than its alternatives, down 5.7% for the month at the worst of the pullback, compared to 8.6% for the S&P 500.
- However, the performance spread quickly tightened with the S&P/TSX finishing the month down 3.0% compared to 3.7% for U.S. stocks.

U.S. equities

- The all-time record of a 15 consecutive S&P 500 positive monthly total return came to an end in February.
- Losses were widespread sector-wise, with Energy and interest rate sensitives such as Staples, Telecommunications and REITs suffering the most. On the other side, Technology managed to finish the rocky month positive.

Commodities

- Crude oil prices suffered from the double whammy of the rising U.S. dollar and oil inventories in February, down from last-month's 3-year high.
- Despite the resurgence of risk aversion, gold prices eased slightly, losing some of its shine with expectations for higher interest rates weighing in.

Foreign exchange

- The USD's 1-year-old downward trend took a breather in February, bolstered by the risk-off episode and Powell's upbeat comments regarding the U.S. economy.
- In that context and combined with softening Canadian economic momentum, the loonie retreated, down 4.2% to 0.78 U.S.

Table 2 Market Returns

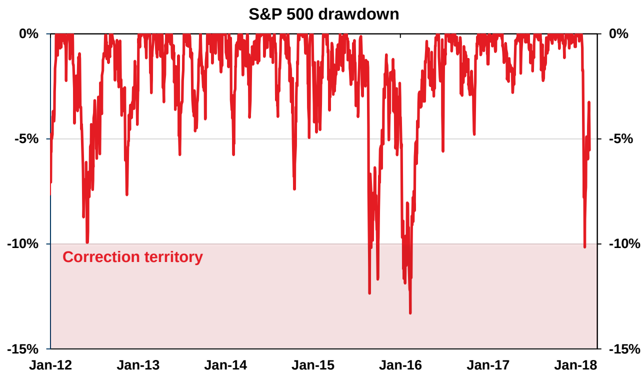
Asset classes	February	YTD	2017
Cash (3-month T-bills)	0.1%	0.2%	0.6%
Bonds (FTSE/TMX Ovr. Univ.)	**0.1%**	**-0.7%**	**2.5%**
FTSE/TMX Short term	0.3%	0.1%	0.1%
FTSE/TMX Mid term	0.5%	-0.7%	1.0%
FTSE/TMX Long term	-0.3%	-1.6%	7.0%
FTSE/TMX Government	0.2%	-0.8%	2.2%
Federal	0.4%	-0.4%	0.1%
Provinces	0.0%	-1.2%	4.3%
Municipales	0.2%	-0.9%	4.7%
FTSE/TMX Corporate	0.0%	-0.2%	3.4%
AA+	0.2%	0.0%	0.7%
A	-0.1%	-0.4%	4.4%
BBB	0.0%	-0.1%	4.0%
BoAML High-Yield (USD)	-0.9%	-0.3%	7.5%
Preferred shares	-1.0%	0.5%	13.6%
Canadian Equities (S&P/TSX)	**-3.0%**	**-4.4%**	**9.1%**
Energy	-6.1%	-11.1%	-7.0%
Industrials	1.3%	-0.5%	19.7%
Financials	-3.2%	-2.4%	13.3%
Materials	-4.0%	-4.6%	7.7%
Utilities	-3.4%	-7.6%	10.8%
Cons. Disc	-3.2%	-3.5%	22.8%
Cons. Staples	-2.7%	-4.5%	7.8%
Healthcare	-10.0%	-13.7%	34.2%
IT	5.8%	11.5%	16.8%
Telecom	-2.1%	-6.6%	14.8%
REITs	-6.7%	-8.5%	10.8%
S&P/TSX Small cap	-4.5%	-6.6%	2.8%
US Equities (S&P500 USD)	**-3.7%**	**1.8%**	**21.8%**
Energy	-10.8%	-7.4%	-1.0%
Industrials	-3.9%	1.1%	21.0%
Financials	-2.8%	3.5%	22.2%
Materials	-5.3%	-1.3%	23.8%
Utilities	-3.9%	-6.8%	12.1%
Cons. Disc	-3.5%	5.6%	23.0%
Cons. Staples	-7.8%	-6.3%	13.5%
Healthcare	-4.4%	1.9%	22.1%
IT	0.1%	7.7%	38.8%
Telecom	-7.1%	-6.5%	-1.3%
REITs	-6.7%	-8.5%	10.8%
Russell 2000 (USD)	-4.0%	-1.5%	13.1%
World eq. (MSCI ACWI)	**-4.2%**	**1.3%**	**24.6%**
MSCI EAFE (USD)	-4.5%	0.3%	25.6%
MSCI EM (USD)	-4.6%	3.4%	37.8%
Commodities (CRB index)	**0.1%**	**2.6%**	**2.2%**
WTI oil (US$/barrel)	-5.2%	1.6%	12.5%
Gold (US$/ounce)	-1.7%	1.2%	12.6%
Copper (US$/tonne)	-2.6%	-4.3%	30.5%
Forex (DXY - US Dollar index)	**1.7%**	**-1.6%**	**-9.9%**
USD per EUR	-2.1%	1.6%	13.8%
CAD per USD	4.2%	2.0%	-6.4%

Source: Datastream 2/28/2018

Guess Who's Back?

After months of uncanny calm and stability, volatility came back forcefully in February. The record-breaking 400+ consecutive days without a 5% pullback ended abruptly, with U.S. equities falling in official correction territory in a matter of just 9 trading days (**Chart 1**).

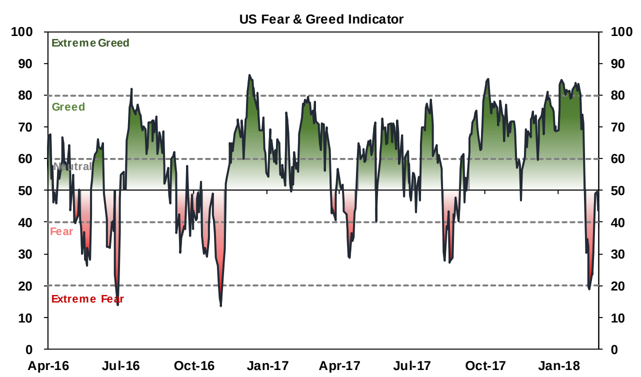
1 An abrupt end to a prolonged period of low volatility…



Source: Datastream

We believe this pullback had more to do with a mean reversion to a more sustainable trend after the best January performance in 30 years, as numerous indicators were suggesting a bit of complacency on the part of investors (**Chart 2**).

2 …and of complacency on the part of investors…

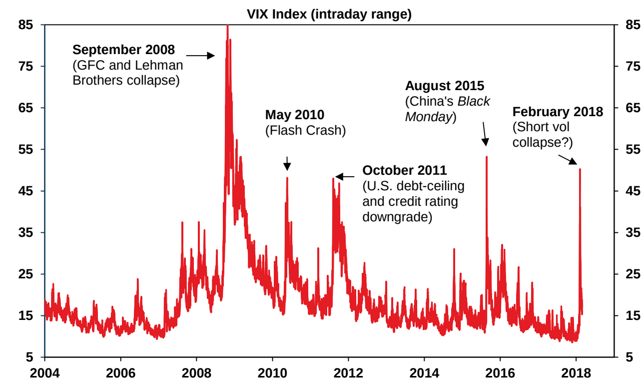


Source: Bloomberg

True, the release of higher-than-expected wage growth on February 2 is what initially sparked the downturn, but the magnitude of the subsequent surge in the Volatility Index suggests the equity meltdown was accelerated by technical factors, namely the collapse of products that sold volatility (**Chart 3**).

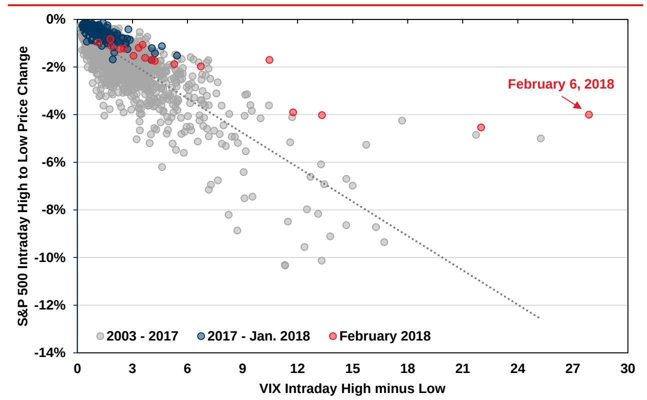
Case in point, February's relationship between the Volatility Index and S&P 500 intra-day moves was completely beyond historical proportions. On February 6, a day with virtually no news other than volatility itself, we saw the biggest daily VIX swing ever, accompanied with a not-so-uncommon 4% high-to-low variation for the S&P 500 (**Chart 4**).

3 …accelerated by the collapse of « short vol » products…



Source: Datastream

4 …as evidenced by a beyond proportion VIX swing



Source: Datastream

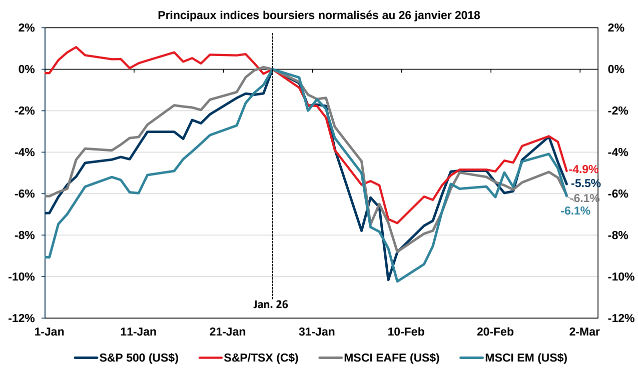
Last month, we stated that:

> *"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."*

Therefore, with (1) macro data suggesting near zero-risk of a recession in the coming quarters, (2) Q4-2017 corporate earnings up double digits, (3) acknowledgement that inflation and volatility were simply getting back toward their average and (4) attractive valuations after stocks fell to the key psychological -10% mark, we decided to tactically augment our equity exposure on February 12, thereby bringing our allocation to 100%.

Since then, global stock indices have rebounded quite sharply, despite a rough month-end, as fears about the implications of accelerating inflation moderated and automatic selling by volatility strategies softened (**Chart 5**).

5 Sharp rebound from global equity indices



Source: Datastream

In the next few weeks, we will continue to closely monitor levels of complacency or market weakness and consider some profit-taking given the very tactical nature of this positioning. Still, with an economic backdrop just as strong as before the pullback and rates set on an upward trajectory, we continue to believe stocks will outperform fixed-income assets in 2018.

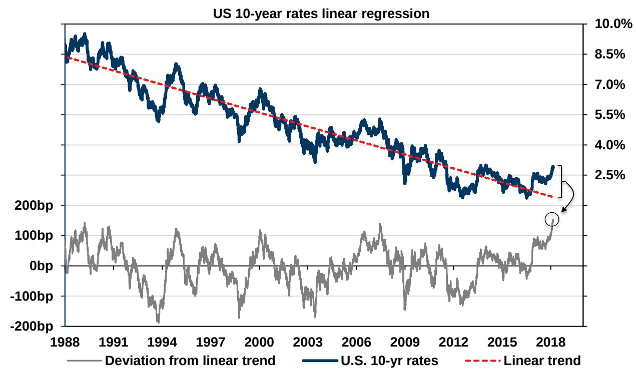
Fixed Income: What's Driving Rates Higher?

Despite what we judged to be exaggerated concerns about accelerating inflation and monetary policy tightening, it remains true that rates are heading higher. In fact, they're already as far apart from their 30-year-long downward linear trend as they've ever been (**Chart 6**).

However, we believe it's important to put that rise into perspective. For one, the recent pick-up in inflation momentum simply confirms what the Fed has been repeating throughout 2017, which is that they expect "year-on-year readings to move up in 2018, before stabilizing around its 2% goal in the medium term" (**Chart 7**). In fact, it is word-for-word what new Fed Chair Jerome Powell reiterated in his testimony to Congress on February 27. Hence, rate-hike expectations have only slightly changed, still largely aiming at 3 moves by the Federal Reserve in 2018, with the first lift set for March 21 (**Chart 8**).

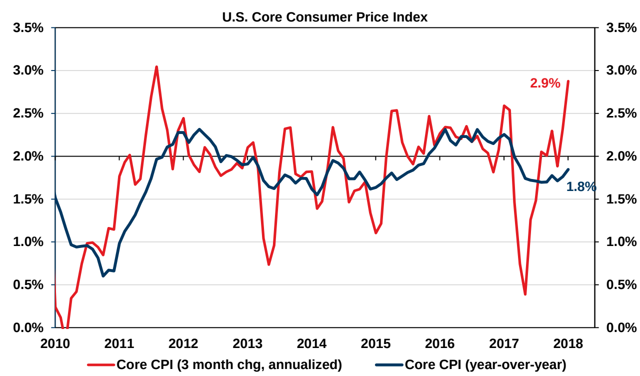
For another, we've yet to see a disruptive surge in government bond yields, having only risen by 13 bps in February compared to 31 bps the month before. Much like the pace of monetary policy tightening, we expect bond yield's run-up to be gradual, with the 3% technical resistance within reach over the next few weeks.

6 Rates breaking from 30-year long downward trend…



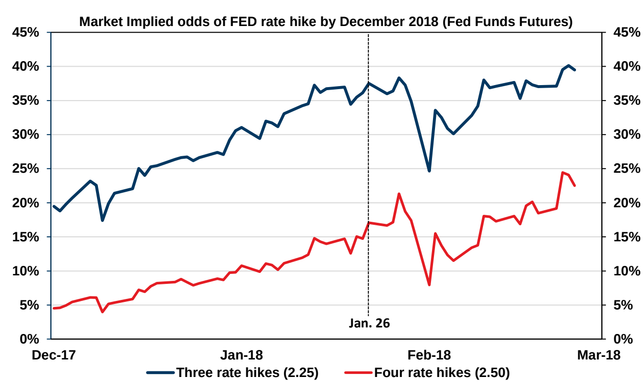
Source: Datastream

7 …as long-anticipated inflation acceleration begins



Source: Datastream

8 Three hikes in 2018 still the most-likely scenario



Source: Bloomberg

Still, considering the paramount importance rate levels have for virtually all asset classes, we thought it important to delve into what exactly is driving rates higher. Using simple assumptions and observable data, we can deconstruct 10-year rates into 3 components: (1) growth expectations; (2) inflation expectations;

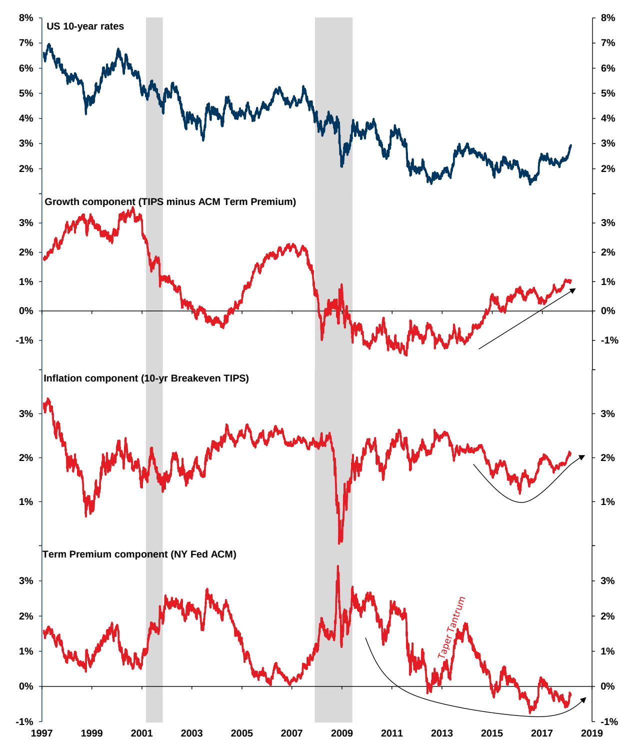
and (3) a term premium, as depicted in the following equations (**Chart 9**):

Nominal Rates = Real Rates + Breakeven Inflation (TIPS)

Real Rates = ACM Term Premium + Growth Expectations

Both nominal rates and break-even inflation TIPS are observable. For the term premium, which reflects the uncertainty surrounding the course of short-term interest rates, we use the Adrian, Crump and Moench (ACM) model from the Federal Reserve of New York[1]. Finally, we assume that the residual represents growth expectations. While we're well aware that this method is far from perfect, we believe results are nonetheless enlightening.

9 Deconstructing U.S. 10-year treasury yields



Source: Datastream.

First, it should be emphasized that much of the rise in yields has been made on the back of improving growth prospects, with both tax reform and synchronicity of global economic activity weighing in. After roughly 6 years in negative territory, its contribution to bond yields should continue to trend higher slowly with no recession in the cards.

Secondly, it should come as no surprise that inflation expectations were a major driver of rising rates as of late. Indeed, since their February 2016 trough of 1.18%, break-even inflation rates increased by almost a full percentage point, now standing at 2.13%. Simply put, inflation prospects came back from abnormally low levels and now hover around the FED target, suggesting limited upside on that front. Still, we wouldn't be surprised, nor concerned, to see TIPS revisit historical highs roughly 40 bps higher. After months of undershooting its inflation target, the Federal Reserve should be comfortable with a symmetric transient overshoot considering that 2% is a target, not a cap.

Last, but not least, is the term premium. A good proxy for risk aversion, it has been negative for most of the last 3 years now. This reflects the massive purchase of longer-term government debt securities by the Fed as well as similar quantitative measures taken by the ECB and BoJ, rendering U.S. debt relatively attractive. Now that the Fed has begun unwinding its balance sheet, one should expect the term premium to "naturally" turn back positive, but the pace at which that happens will be key.

In short, as long as rates are pushed higher for "good reasons" – a combination of rising growth prospects, stable inflation and gradual monetary policy/term premium normalization – there's no reason to be concerned. In such an environment, we advise staying underweight in government bonds and continue to favour non-traditional, unconstrained fixed-income solutions.

Commodities: OPEC is Crude Oil's Central Bank

The Fed potentially letting inflation run a bit higher than its 2% threshold may be imitated by OPEC. The Cartel also seems willing to follow a similar strategy as it announced it would prefer the oil balance to run a higher-than-expected deficit to limit the potential of a supply glut:

> *"If we have to err on over-balancing the market a little bit, so be it, … Rather than quitting too early and finding out we were dealing with less reliable information … Stay the course and make sure that inventories are where the industry needs them"*
>
> Saudi Arabia Energy Minister Khalid Al-Falih

This plan should be taken seriously, especially when compliance by countries tied to the OPEC+Russia production cut has been spectacular. Letting deficits run hot is a logical strategy for OPEC, as it is easier to use spare capacity to fill the underproduction gap than to cut too early and then have to reach a new deal capping output to reign in surpluses.

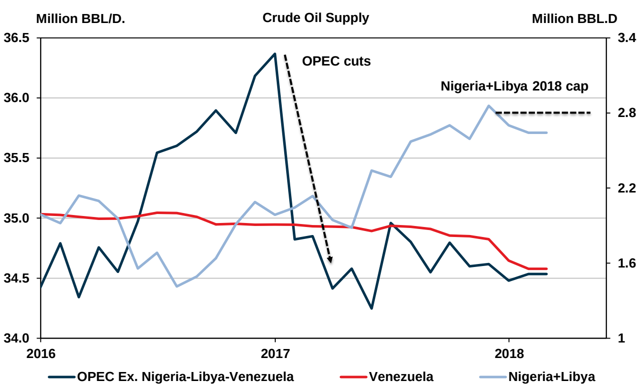
The Cartel also wants to form a "supergroup" with Russia by the end of the year, which would add a more permanent

[1] Pricing the Term Structure with Linear Regressions, Tobias Adrian, Richard K. Crump, and Emanuel Moench, August 2008

twist to the recent cooperation between the two partners and indicate that the exit strategy from the deal may be much more gradual than initially expected.

This OPEC re-emergence as the main arbitrator of oil fundamentals is going to support prices and materially decrease the potential of a correction in energy levels, especially now that the supply-and-demand picture seems roughly to be balanced for 2018. Nigeria and Libya are now close to max output capacity and have agreed to cap their production at the 2017 level, while Venezuela continues to experience troubles (**Chart 10**). Should any production shortfall happen for these countries, other members of the Cartel could act as a stabilizer by increasing their production accordingly. This means that the projected 1.6 million barrels per day increase of U.S. supply for 2018 will be totally absorbed by worldwide demand, which is expected to grow by the same amount.

10 All is set for a stable OPEC output



Source: Datastream

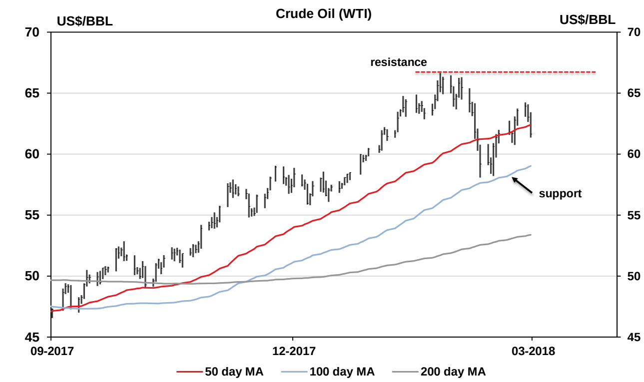
Technically, WTI wasn't spared from the risk-off selloff from the beginning of the month, but it imitated all other risky assets and has rebounded since (**Chart 11**). We expect the 100-day moving average (MA) to act as a support while a resistance level could be found at $66.50, i.e. recent highs.

Going forward, for the rest of 2018, we expect crude oil to trade within the $60 to $70 range. Increased demand from synchronized global growth should help keep prices over the lower threshold while any increase over the upper echelon would be met by a ramp-up in U.S. shale oil activity. This is also the range at which OPEC seems comfortable, so there's a strong incentive from both fundamentals and the Cartel to keep prices within those bounds.

Currencies: Short-term Forces vs Long-term View

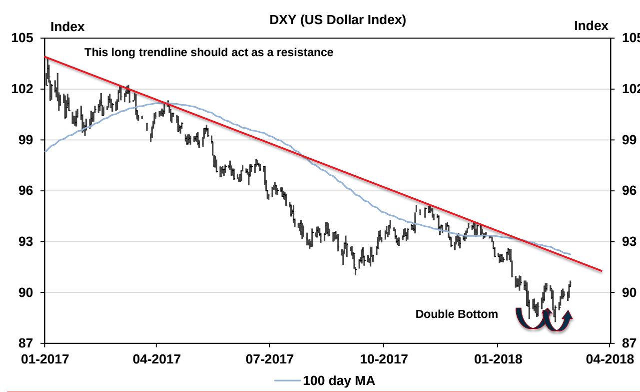
Propped up by flight-to-safety flows and concerns that the Fed will be more aggressive in fighting inflation via hikes, the greenback finally snapped out of a 3-month losing streak. The currency could also bounce back further as speculators are still massively short which limits the downside potential. Technicals show that potential strength is ahead, and the DXY recently formed a double-bottom, which is a reversal pattern (**Chart 12**). We expect it to witness resistance at the 100-day MA which coincides with a trendline set in January 2017.

11 OPEC is comfortable with crude between 60$ and 70$



Source: Datastream

12 Technicals point towards a short-term rebound

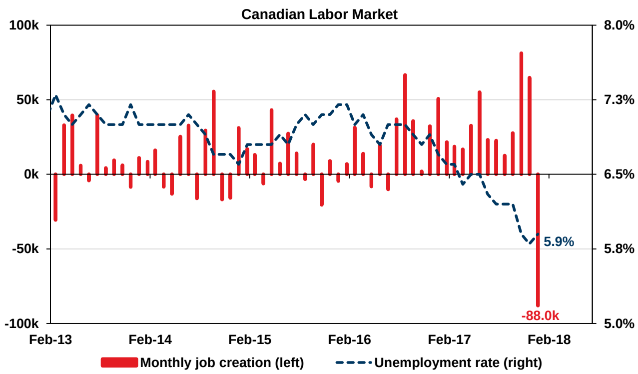


Source: Datastream

However, our medium-to-long term assumptions for the U.S. dollar remain intact. We still believe it will eventually head lower. It's not so much that we view the currency itself as weak, but that other FX pairs have a better outlook as central banks are shifting their stance on the more hawkish side as synchronized growth takes hold. Consequently, once the temporary short-term forces subside, we expect the greenback to weaken further.

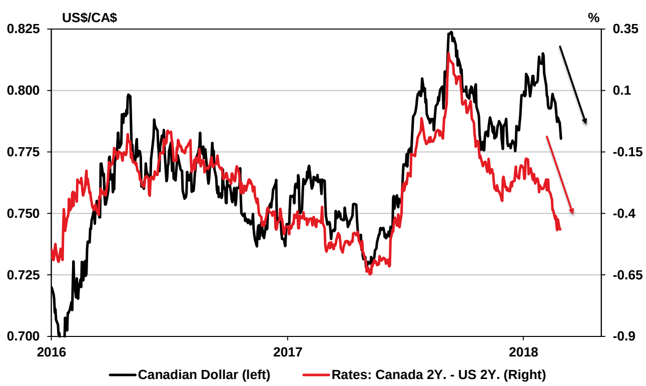
In last month's letter, we argued that the loonie's direction would depend on the evolution of economic figures on both sides of the border. In February, we witnessed an example of how the Canadian dollar reacted to the disappointing employment numbers in Canada as the USD-CAD pair weakened and the yield differential between Canada and the U.S. widened (**Chart 13 and 14**).

13 Disappointing labour market data …



Source: Datastream

14 … dragged down the yield spread … and the loonie



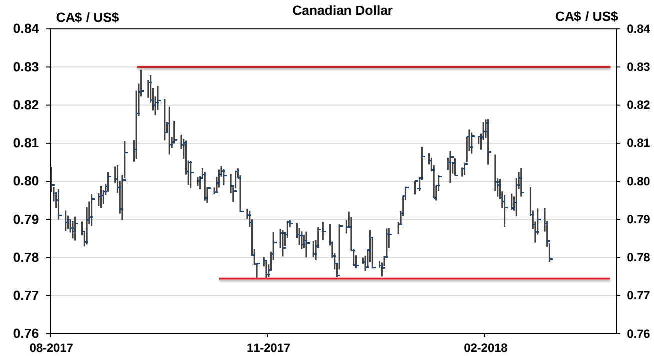
Source: Datastream

The future remains unclear for now. Foreign investors are still wary about the country's real estate situation and the impact of a potential failure to sign a NAFTA-2 agreement. We also haven't seen any meaningful progress on the Western Canadian Select/WTI spread, which means energy price appreciation will only have a limited influence on the Canadian dollar in the near-term. As such, once again, data dependency on both sides of the border will determine the path of the loonie going forward, and expect it to trade in the 0.77$ and 0.83$ range (**Chart 15**) until we get some form of clarity about the risks we just enumerated.

Equities: Technical Selloff => Tactical Opportunity

As stated in the introduction, with no change in the economic backdrop plus valuations falling closer to their long-term average, we decided to opportunistically add to our equity exposure on February 12, bringing the asset class total allocation to 100% (**Chart 16**).

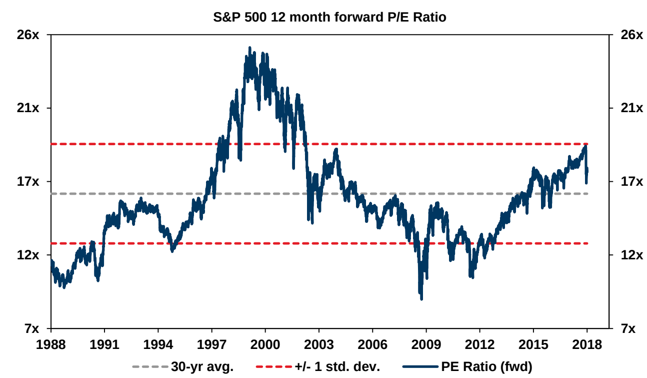
15 Will the 0.75 $ support hold?



Source: Datastream

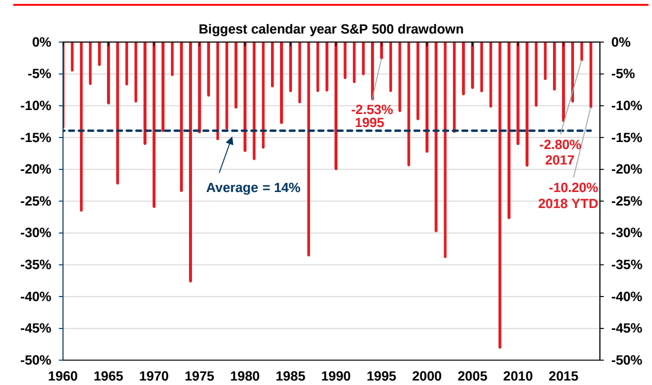
Last year was exceptional on many levels, but especially for the calmness of risk assets. For instance, the biggest loss you could have realized by holding the S&P 500 in 2017 was 2.80% (!), inches below the 1995 all-time record of -2.53% (**Chart 17**). Having already experienced a 10.2% drawdown in 2018, we view U.S. stock volatility as simply back in line with its historical average.

16 Mean reversion in U.S. equity valuations…



Source: Datastream

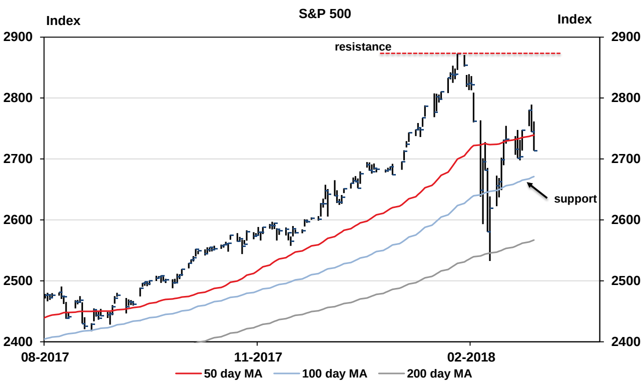
17 … and S&P 500 drawdowns



Source: Datastream

All in all, much of February's market action appeared to be driven by technical price levels, with supports being broken and resistances holding steady (**Chart 18**). The low point came in on February 9, once the intraday lows touched the 200-day MA, and the S&P 500 has never looked back since. The 50-day MA is still a point of contention between bulls and bears. Ultimately, we believe the 100-day MA will act as a support and on the upside, we expect some form of resistance around the 2870 level, which marked the end-of-January highs.

18 The fight over the 50 day MA continues



Source: Datastream

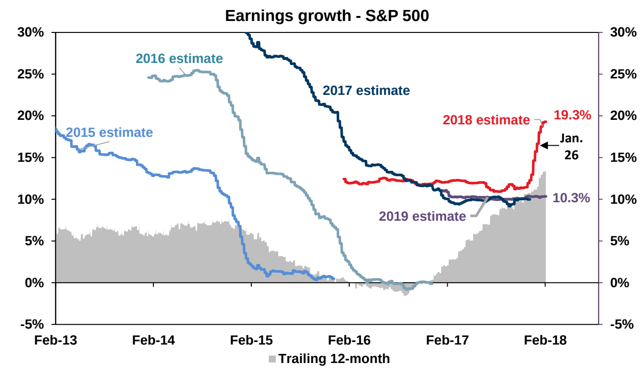
From a fundamental point of view, our max overweight decision was also supported by the Q4-2017 earnings season which continued to depict healthy corporate fundamentals (**Chart 19**). When most attention was dragged by headlines such as "*Dow Plunges 1175 – worst point decline in history,*"[2] earnings expectations for 2018 were actually on the rise, up from 16.7% on January 26 to 19.3% as of February 28. These had been supported by positive earnings guidance coming from S&P 500 companies' senior management (**Chart 20**).

19 Companies continue to deliver stellar earnings…

	Reported (%)	Q4/17 YoY Earnings Growth (Blend Estimate)*	Beat (%)	Met (%)	Missed (%)
S&P 500	**95%**	**15.2%**	**76%**	**9%**	**15%**
Energy	100%	124.1%	75%	9%	16%
Materials	100%	35.7%	88%	8%	4%
Industrials	99%	7.5%	77%	7%	16%
Consumer Discretionary	83%	10.0%	75%	7%	18%
Consumer Staples	91%	12.1%	68%	16%	16%
Health Care	90%	8.6%	84%	7%	9%
Financials	100%	13.6%	78%	7%	15%
Information Technology	97%	20.1%	85%	6%	9%
Telecommunication Services	100%	4.8%	33%	0%	67%
Utilities	96%	13.0%	74%	7%	19%
Real Estate	100%	-2.4%	48%	18%	33%

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.

20 … and 2018 projected earnings to ramp up



Source: Datastream

For the time being, we remain geographically neutral, but we are considering an overweight position in emerging markets. This will be the subject of a Strategic Report we expect to publish in the coming weeks.

[2] *CNN Money, February 5, 2018*