NATIONAL BANK

ASSET ALLOCATION STRATEGY

November 1, 2018

October Blues

Highlights

- In last month's piece, we stated that "*it is not far-fetched to expect a pick up in volatility over the next few weeks*". And, in this regard we can say that we were served with the mix of rising rates, inflation fears, trade tensions, slowing global growth, fear of "peak earnings," and U.S. midterm elections creeping closer, ultimately making the volatility pendulum swing back the other way.
- Stepping back from the wild daily gyrations the global equity indices exhibited in October, one can hardly conclude other than that the economic and corporate backdrop remains just as sound. The more we advance in the business and monetary policy cycle, the more things are going to get challenging, especially in this context of rising political uncertainty. Nevertheless, fundamentals suggest that it is too early to turn outright bearish and that October's pullback is overdone. We, therefore, start November with our allocation in favour of equities unchanged.
- Largely positive earnings results from U.S. corporations have been particularly ill-received by market participants. We see no more than a normal degree of cautious guidance from corporate management, and that's probably why forward-earnings growth expectations stood their ground throughout October's stock market rout.
- We keep our geographical allocation unchanged as we expect U.S. stocks to bounce back faster than their peers, fueled by a stronger economic backdrop and earnings outlook. We recognize that the S&P 500's dominance is obviously not eternal, but prefer to wait for a clear leadership reversal signal from our relative momentum model over acting preemptively.
- Despite doing relatively better than stocks in October, prospects for fixed-income assets remain poor at this stage of the business cycle and with North American central banks set on a course towards monetary policy normalization. We also address the downturn in Canadian preferred shares, which we conclude to be the result of market structure and liquidity problems only. The situation, therefore, should resolve itself soon.
- For the Loonie, the currency didn't react the way we anticipated following the USMCA agreement. Still, we maintain our favourable bias towards the Canadian dollar as we expect the currency to rebound once the volatility in equity markets subsides.
- Despite the recent downturn in crude oil, we still think prices will eventually resume on the upside. But, the clock is ticking leading up to H2-2019 which marks the period when pipelines are expected to come online and help alleviate the sizeable discount for crude produced in the Permian Basin.

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

- Despite a turbulent month for risk assets, safer government bonds finished the month slightly weaker with 10-year bond yields fractionally higher on both sides of the border.
- Government bond yields of shorter maturities increased at a faster pace last month, especially in Canada where the Central Bank hiked its policy rate for the third time this year in addition to dropping its reference to "gradual" rate hikes – a move interpreted as potentially hinting at a more aggressive path to monetary tightening.

Canadian Equities

- This was the S&P/TSX's worst monthly performance since September 2011, down 6.3% (total return) as global risk-aversion surged amid mounting concerns over rising rates, trade tensions, and a slowing world economy.
- Losses were broad based sector-wise, with the Healthcare sector markedly lower as marijuana stocks exhibited extreme volatility in this first month of legalization.

U.S. Equities

- Stocks also suffered south of the border, with the S&P 500 closing the month 6.8% lower, its worse showing in 7 years, as anxiety about slower growth has jolted some investors.
- Technology giants have been among the most sharply sold stocks in October, while only defensive sectors such as utilities and consumer staples managed to stay afloat.
- Despite the downturn, the S&P 500 remains among the few indices positive after 10 months in 2018.

Commodities

- Investors' anxieties with regard to global growth prospects were also reflected in crude oil prices, down 10.7% in October.
- On the other hand, gold was one of the rare assets trading higher during the global market turmoil, benefitting from increased demand for safe havens without suffering a drag from rising interest rates.

Foreign Exchange

- The U.S. dollar index strengthened slightly last month, finishing the period at its highest level since June 2017, supported by a global sense of caution and some disappointing economic growth figures outside the country.
- At home, the Canadian dollar got a brief boost from a somewhat hawkish Bank of Canada, but nevertheless closed weaker than a month earlier, along with crude oil prices and other cyclical assets.

Table 2 **Market Returns**

Asset classes	October	YTD	12 months
Cash (3-month T-bills)	0.1%	1.0%	1.2%
Bonds (FTSE/TMX Ovr. Univ.)	**-0.6%**	**-1.0%**	**-0.6%**
FTSE/TMX Short term	-0.1%	0.4%	0.1%
FTSE/TMX Mid term	-0.4%	-0.9%	-1.1%
FTSE/TMX Long term	-1.5%	-3.0%	-1.3%
FTSE/TMX Government	-0.6%	-1.2%	-0.8%
Federal	-0.3%	-0.5%	-0.7%
Provincial	-0.9%	-1.9%	-0.9%
Municipal	-0.7%	-1.4%	-0.6%
FTSE/TMX Corporate	-0.6%	-0.4%	-0.1%
AA+	-0.2%	0.3%	-0.1%
A	-0.9%	-1.3%	-0.9%
BBB	-0.7%	-0.2%	0.3%
BoAML High-Yield (USD)	-1.6%	0.9%	0.9%
Preferred Shares	-2.7%	-0.5%	0.3%
Canadian Equities (S&P/TSX)	**-6.3%**	**-5.0%**	**-3.4%**
Energy	-9.1%	-10.2%	-9.3%
Industrials	-5.9%	6.0%	6.9%
Financials	-6.3%	-4.2%	-3.2%
Materials	-4.6%	-14.2%	-11.4%
Utilities	-2.6%	-10.1%	-10.7%
Cons. Disc	-6.4%	-10.8%	-9.7%
Cons. Staples	-0.7%	-4.2%	-0.6%
Healthcare	-17.6%	7.0%	57.2%
IT	-8.1%	15.7%	16.4%
Telecom	-2.1%	-4.7%	-3.5%
REITs	-3.0%	6.0%	8.6%
S&P/TSX Small Cap	-7.6%	-11.7%	-9.1%
US Equities (S&P500 USD)	**-6.8%**	**3.0%**	**7.3%**
Energy	-11.3%	-4.6%	1.8%
Industrials	-10.8%	-6.5%	-1.0%
Financials	-4.7%	-4.6%	0.6%
Materials	-9.5%	-11.9%	-9.4%
Utilities	2.0%	4.7%	1.0%
Cons. Disc	-11.3%	7.0%	15.2%
Cons. Staples	2.3%	-1.1%	6.8%
Healthcare	-6.7%	8.8%	11.3%
IT	-8.0%	11.0%	12.3%
Telecom	-5.8%	-5.0%	6.5%
REITs	-1.7%	0.0%	2.4%
Russell 2000 (USD)	-10.9%	-1.6%	0.6%
World eq. (MSCI ACWI)	**-7.5%**	**-3.5%**	**0.0%**
MSCI EAFE (USD)	-8.0%	-8.9%	-6.4%
MSCI EM (USD)	-8.7%	-15.4%	-12.2%
Commodities (CRB index)	**0.2%**	**-3.8%**	**-2.7%**
WTI Oil (US$/barrel)	-10.7%	8.0%	20.1%
Gold (US$/ounce)	2.0%	-6.7%	-4.2%
Copper (US$/tonne)	-3.6%	-16.2%	-11.4%
Forex (DXY - US Dollar index)	**2.1%**	**5.4%**	**2.7%**
USD per EUR	-2.4%	-5.6%	-2.7%
CAD per USD	1.9%	4.6%	2.1%

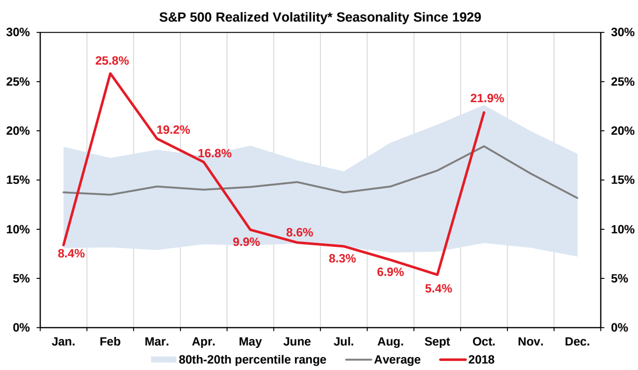
Source: Datastream 10/31/2018

October Blues

In last month's piece, we stated that "*it is not far-fetched to expect a pick up in volatility over the next few weeks, if only from a statistical point of view. Despite what one might think, stocks have been remarkably calm over the last three months south of the border and, if history is any guide, October seems to be the perfect stage for mean reversion.*"

In this regard, we can say that we were served, with the mix of rising rates, inflation fears, trade tensions, slowing global growth, fear of "peak earnings" and U.S. midterm elections creeping closer ultimately making the volatility pendulum swing back the other way (**Chart 1**).

1 The volatility pendulum swung the other way in October



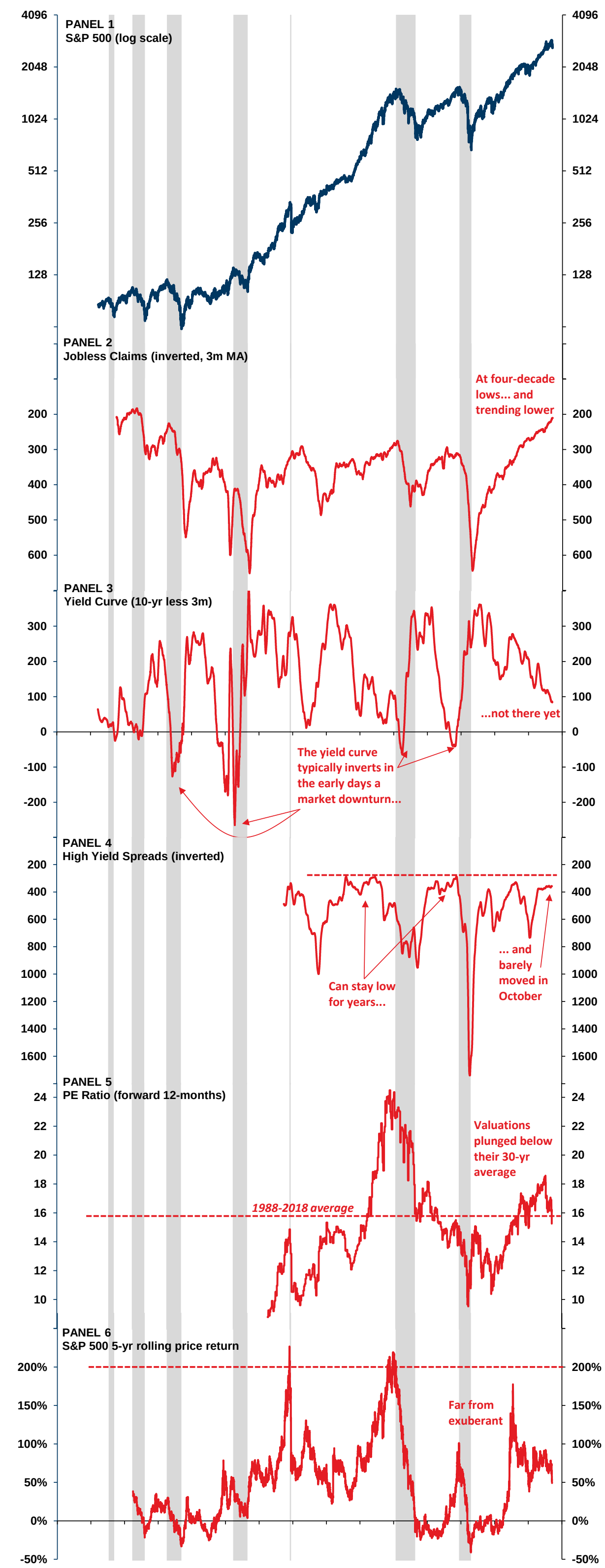
Source: Datastream, Bloomberg
*Volatility measured by the annualized standard-deviation of daily returns observed during the month.

Nevertheless, we also mentioned that "*barring new information significantly changing the global economic and earnings outlook, we remain confident that stocks will continue to outperform fixed-income assets through the end of the year,*" hence why we kept unchanged our allocation in favour of equities.

Stepping back from the wild daily gyrations the global equity indices exhibited in October, one can hardly conclude other than that the economic and corporate backdrop remains just as sound (**Chart 2**).

First, we acknowledge the fact that many U.S. economic indicators are at record levels, which leads many to believe that they can only go down from there. There is little doubt that many will soften over the coming quarters, as the boost from tax cuts gradually fades and Fed rate hikes prevent the economy from overheating. Still, we have not seen the trend reverse yet (see jobless claims in **Chart 2, Panel 2** as an example). Moreover, slower growth is not an impediment to risk asset outperformance. The real threat is a recession, and the data simply does not suggest that this is a likely scenario in the near future.

2 Fundamentals suggest it is too early to turn bearish



Second, monetary policy is not yet in restrictive territory, as suggested by a positively slopping yield curve (**Chart 2, Panel 3**). One should keep in mind that the U.S. Federal Reserve rate hikes are simply directed toward a return to neutral at a pace that depends on financial markets stability. Moreover, the 2006 episode showed that stocks can peak months after an outright negative curve. So, in our view, there is no need to act preventively.

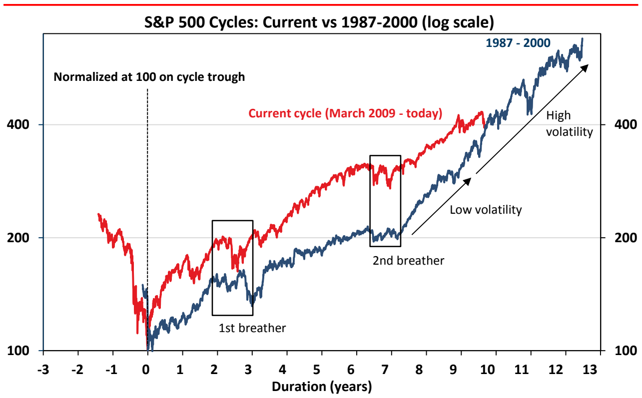
Third, credit quality is not flashing red (**Chart 2, Panel 4**), and we believe the fact that high-yield spreads have barely blinked through the recent equity market correction supports the view that the selloff is overdone.

Fourth, for the first time since January 2016, equity valuations (15.25x forward 12-month earnings) have fallen below their long-term average (15.6x), which significantly improves the risk-reward of stocks, especially over a longer horizon (**Chart 2, Panel 5**). No hyperbole here.

Fifth, with over 9 years without a +20% correction, it's easy to believe that gains are exaggerated. However, at 49%, the last 5 years of equity returns are actually much closer to their long-term average (47%) than the 1987 and tech bubble exuberance (**Chart 2, Panel 6**).

It bears repeating that higher volatility is to be expected as the cycle ages and that it doesn't have to be to the detriment of positive returns, as evidenced by the 1987-2000 run (**Chart 3**). Case in point, the last 3 years of the period saw the S&P 500 gain 77%[1], despite going through 5 greater than 10% corrections.

3 Higher volatility is to be expected as the cycle ages



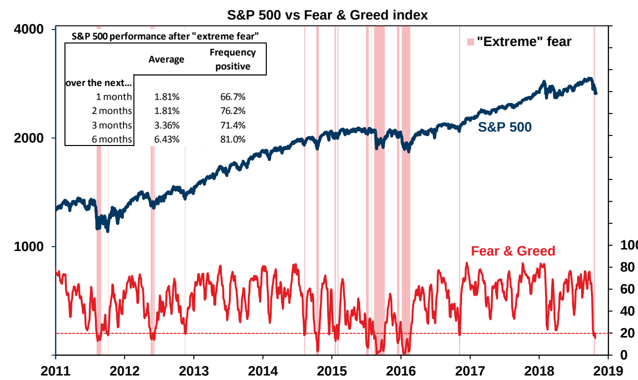
Source: Datastream

With that being said, now is clearly not the time for complacency. The more we advance in the business and monetary policy cycle, the more things are going to become challenging, especially in this context of rising political uncertainty. Nevertheless, fundamentals suggest it is too early to turn outright bearish and that October's pullback is overdone. We therefore start November with our allocation in favour of equities unchanged.

Equities: All Spooked

The upsurge in volatility has left many in search of a single culprit. Some (like the U.S. President, for instance) blamed it on the Fed, others on ever-escalating trade tensions, questions about global growth, coming midterm elections, cautious guidance from corporations, and so on. While these elements certainly called for volatility closer to historical averages, we believe the magnitude of the downturn reflects an exaggerated sense of fear, not a turn in fundamentals. The good news is that "extreme fear" episodes are not unusual and are typically short-lived, with the S&P 500 up 81% of the time over the 6 months after our Fear & Greed Index drops below 20 (**Chart 4**).

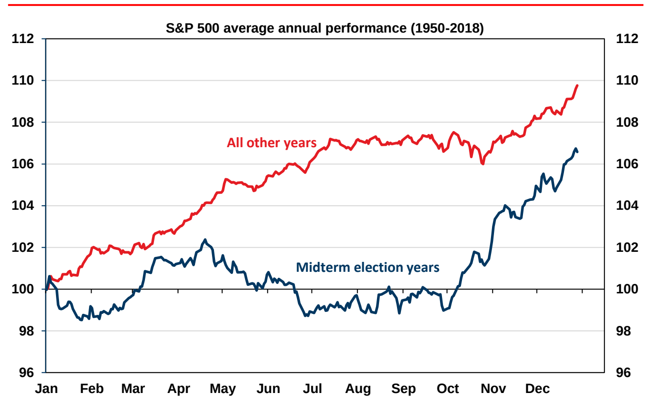
4 A fair dose of fear just in time for Halloween



Source: Datastream

What's also perhaps not so unusual is the fact that U.S. equities are only marginally positive after 10 months in 2018, a midterm election year. Indeed, a simple study of S&P 500 data since 1950 illustrates that stocks tend to be directionless until just before the ballot (**Chart 5**).

5 Will the typical midterm election year pattern hold?



Source: Datastream

[1] From June 10, 1997 to March 24, 2000.

For now, the consensus is that Democrats will prevail in the House of Representatives and Republicans will keep the Senate, which shouldn't materially impact either U.S. policy direction or the economic outlook. Still, whatever the outcome of the November 6 election, let us reiterate that what ultimately matters for equities is companies' capacity to grow profits, which they've once again done remarkably well over the last quarter (**Chart 6**).

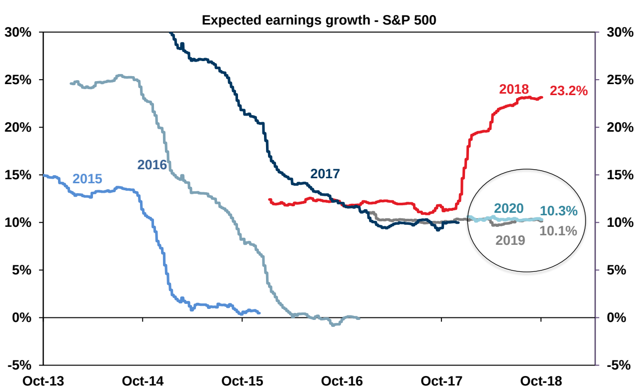
6 Last quarter earnings are coming in strong ...

	Earnings Summary - S&P 500				Q3/2018 YoY%
	% Reported	% Beat	% Met	% Missed	Blend*
S&P 500	67%	77%	9%	14%	26.2%
Comm. Sev.	48%	92%	0%	8%	24.8%
Technology	61%	90%	5%	5%	26.5%
Utilities	48%	86%	7%	7%	9.2%
Discretionary	55%	81%	6%	14%	22.6%
Health Care	65%	80%	10%	10%	15.5%
Financials	85%	75%	11%	14%	42.8%
Staples	59%	74%	21%	5%	10.0%
Industrials	77%	73%	9%	18%	18.5%
Real Estate	84%	70%	19%	11%	4.4%
Energy	70%	62%	0%	38%	100.7%
Materials	58%	57%	7%	36%	30.1%

Source: Datastream
*Blends actual EPS growth with expectations for those yet to report.

Even so, those largely positive results have been particularly ill-received by market participants who are presumably looking for reasons to worry. We see no more than a normal degree of cautious guidance from corporate management, and that's probably why forward-earnings growth expectations have barely moved through October's stock market rout (**Chart 7**).

7 ... and 2019/2020 expectations are holding firm

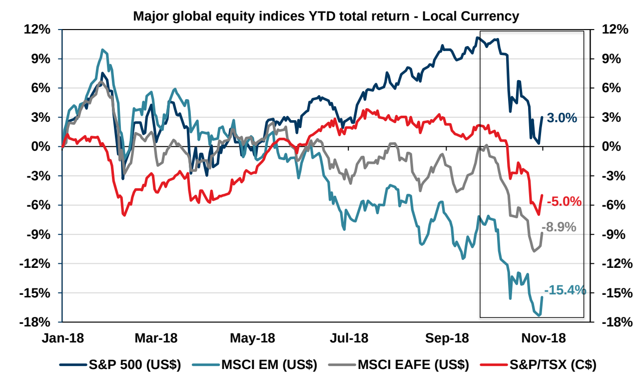


Source: Datastream

Beyond the United States, one might have thought that other global indices would enjoy a little respite as they were all substantially lagging the S&P 500, year-to-date (**Chart 8**).

Quite interestingly, North American leadership persisted in October, as both the S&P 500 and S&P/TSX fared better than

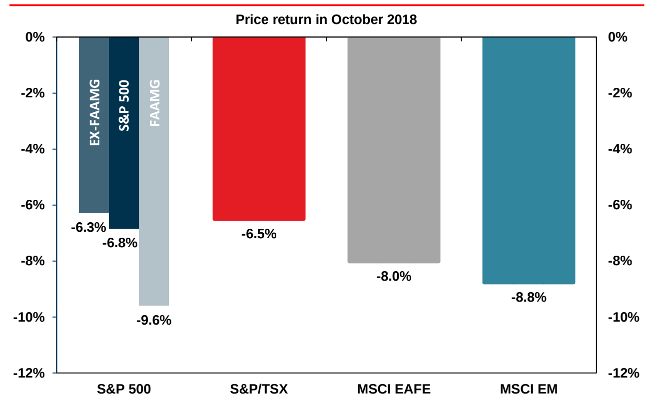
8 No change in geographical leadership in October...



Source: Datastream

emerging markets and EAFE stocks. What's more, the S&P 500 remained ahead despite the top 5 tech giants (Facebook, Apple, Amazon, Microsoft, and Google) deeply correcting which, as we've argued in the past, reflects better market depth than many seemed to believe (**Chart 9**).

9 ...despite a steep correction by U.S. technology giants

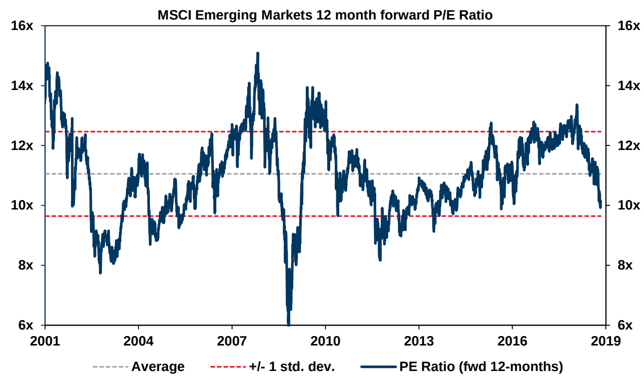


Source: Datastream

Under these circumstances, we keep our geographical allocation unchanged (neutral S&P/TSX and MSCI EM, overweight S&P 500, and underweight EAFE) as we expect U.S. stocks to bounce back faster than their peers, fueled by a stronger economic backdrop and earnings outlook.

We recognize that S&P 500 dominance is obviously not eternal, there are risks that potential tariffs on all Chinese exports end up backfiring on U.S. corporations, and the fact that Emerging Markets valuations are looking increasingly attractive (**Chart 10**, next page).

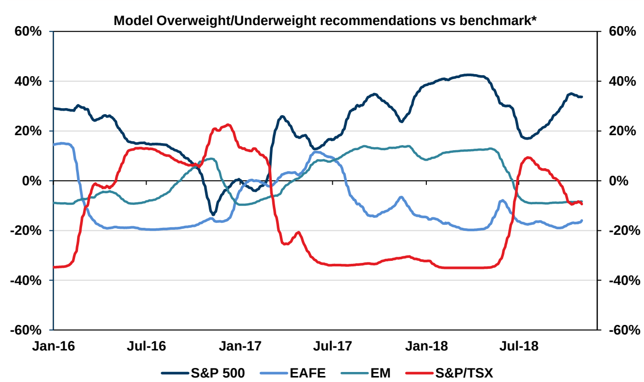
10 EM value proposition increasingly attractive…



Source: Datastream

Still, we prefer to wait for a clear leadership reversal signal from our relative momentum model over acting preemptively (**Chart 11**).

11 … but still waiting for a leadership reversal signal



Source: Datastream
Benchmark = 35% S&P 500, 35% S&P/TSX, 20% MSCI EAFE, 10% MSCI EM

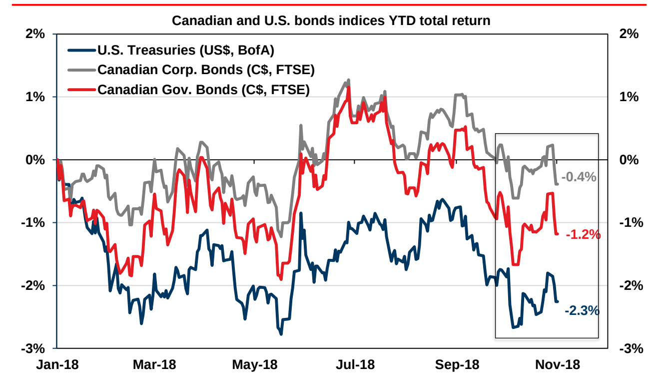
Fixed Income: Business-as-usual

It is hard to believe that equity markets sold off in October when you look at most fixed-income assets behaviour over the last few weeks. True, the rapid rise in government bond yields early in the month had its share of responsibility in the stock market turmoil, but they've only slowly and partly recouped losses as the equity sell off intensified, exhibiting a level of volatility that is not likely to mark history (**Chart 12**).

Similarly, U.S. high-yield and BBB credit spreads have barely moved, and are surely not indicative of a bear market in risk assets at these levels (**Chart 13**).

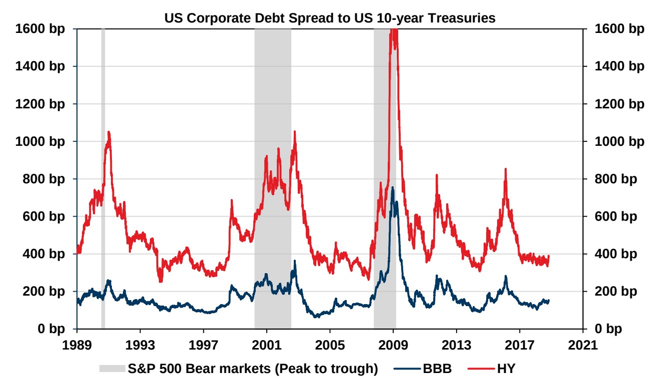
Therefore, despite doing relatively better than stocks in October, prospects for fixed-income assets remain poor at this stage of the business cycle and with North American central banks set on a course toward monetary policy normalization.

12 Business-as-usual for government bonds …



Source: Datastream

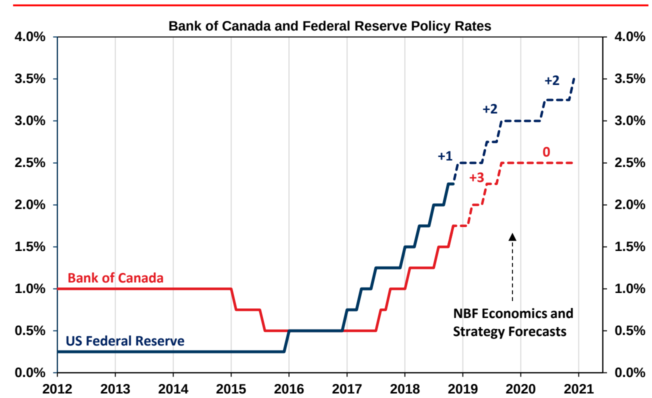
13 … and credit spreads in October



Source: Datastream

According to National Bank's Economics & Strategy Group, both the Bank of Canada and the U.S. Federal Reserve should hike their respective policy rates 3 more times before 2019's year end (**Chart 14**).

14 More rate hikes are coming



Source: Datastream

For their part, preferred shares surely did not have the luxury of snoozing during the recent sell off permeating equity markets. This repricing of volatility has investors rushing for the exits. As most of the retail money invests in preferred shares via ETFs, any flows in or out of these fund impact indiscriminately of individual assets. Panic added to liquidity constraints constitute a toxic mix which can be very detrimental to returns.

In our view, the current downturn is significantly different from 2015 (**Chart 15**) where energy credit, banking credit via real estate exposure, and lower interest rates combined to create a perfect storm which resulted in a loss of 28%. The price action of the last few weeks seems to result from market structure and liquidity problems only, and we believe the situation should resolve itself soon.

15 **2018 is not 2015**

Source: Datastream

Consequently, we do not believe now is the time to flee preferred shares. We still believe the BoC's monetary policy will push yields higher and support the asset class.

Currencies: Muted Volatility

Much like fixed-income assets, the U.S. dollar's reaction to the equity sell off has been relatively muted in October. This development is surprising, as the environment is conducive to Greenback appreciation.

For example, Europe is faced with its own internal problems regarding a Brexit that is getting increasingly contentious, the Italian government stand-off against the European union regarding its fiscal policy, and the Eurozone GDP growth coming in lower than consensus (0.2% quarter-on-quarter vs. consensus of 0.4%) for Q2-2018.

Further east, the Yuan is feeling the brunt of trade tensions as China is trying to grapple with an acrimonious U.S. President pushing on tariffs and adding pressure on the country's already weakening growth (**Chart 16**).

16 **The current environment is unfriendly for the Yuan**

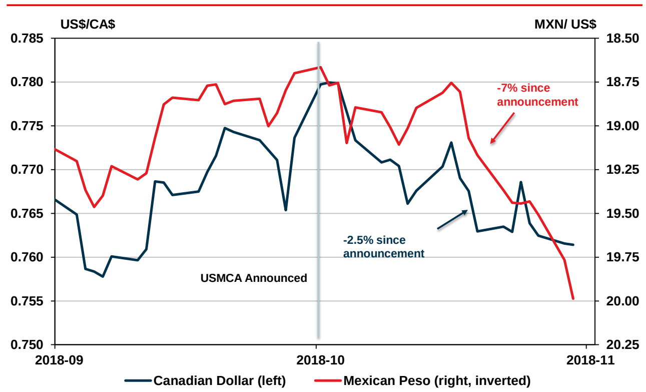
Source: Datastream

The government is trying some new defensive measures to prop up some problem areas, such as tax cuts to car purchases, lowering reserve requirements to cash lenders, or tools to support credit issuance. However, the jury is out on the effectiveness of such a plan.

Consequently, as long as headwinds to growth abroad remain at the forefront of economic news and the risk-off mindset is persisting, we expect the USD to have some support or appreciate.

For the Loonie, the currency didn't react the way we anticipated following the USMCA agreement. The performance from the Canadian dollar and the Mexican peso during October tends to portray a deal that was less favourable to both countries than what was initially expected (**Chart 17**).

17 **A worse deal than anticipated for Canada and Mexico?**

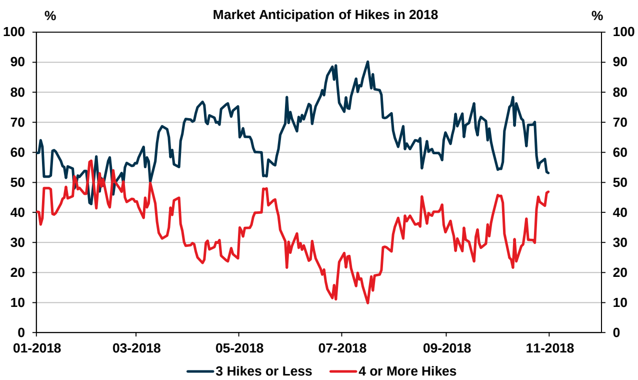


Source: Datastream

In retrospect, it means that markets had probably already discounted the deal as very likely, and there was much more downside potential from a deterioration in negotiations or terms unfavourable to U.S. partners than upside from a positive outcome.

On the monetary-policy side, the BoC hiked its target rate to 1.75%, but the tone of the statement and the following press conference focussed on the removal of the term "gradual" from its previous decisions. While Mr. Poloz stresses that the objective of such a change is to give the governing council more flexibility in setting future rate decisions, the market interpreted this as more hawkish and the probabilities of a December hike now stand at 45% (**Chart 18**).

18 Close to a coin toss for BoC action in December



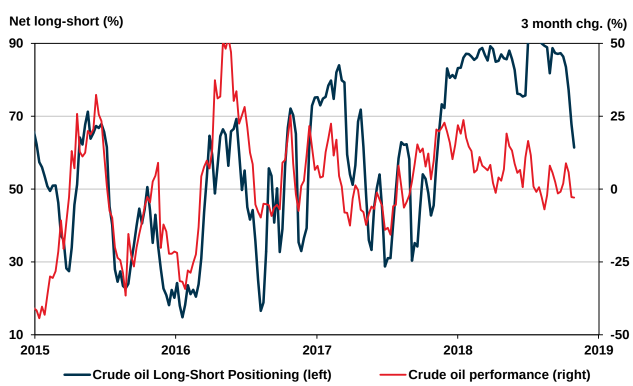
Source: Datastream

In conclusion, despite the disappointing price action since the USMCA signing, we maintain our favourable bias towards the Canadian dollar as we expect the currency to rebound once the volatility subsides in equity markets.

Commodities: Equilibrium Nears

Commodities and crude oil were not spared by the risk-off mindset. Speculators reduced their long exposure (**Chart 19**), and prices dropped 10.8% for the month due to fears a global slowdown would translate to lower demands down the line, particularly from China.

19 Risk-off mindset pushes speculators to the sidelines



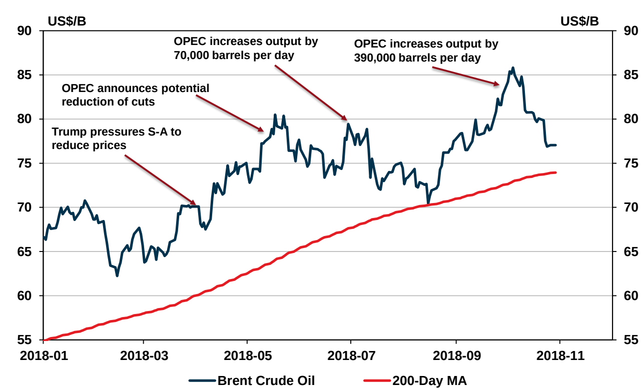
Source: Datastream

This development highlights the main factor which would stop energy levels from increasing in the short to medium term. Whether China's problems are caused by trade tensions, a hard landing via governmental reforms, or both, changes very little in the grand scheme of things. If incremental demand growth slows, energy prices will drop no matter the cause, and China remains the main contributor to that risk.

The support for energy prices increasing comes from potential supply disruptions that act as a risk premium as the probabilities of Iran, Venezuela, Libya, or Nigeria having problems are still major points of concern. While OPEC does respond to those types of production shortfalls by increasing its activity, it does so with a lag which usually translates to crude oil appreciation. Geopolitics also play a role. Most major global actors and countries in the Middle East all have incentive to maintain some form of status quo. But, the region remains volatile and a hit on any production centre could materially impact the supply-and-demand picture.

OPEC seems to follow an informal objective of maintaining Brent oil prices between $70 and $80 despite not explicitly announcing it (**Chart 20**). Whether they succeed or not remains to be seen. After all, crude oil remains a fairly volatile commodity, but we nonetheless expect some form of stabilization effects.

20 Between 70$ and 80$ is the range favored by OPEC



Source: Datastream

Despite the recent downturn, we still think prices will eventually resume on the upside. But, the clock is ticking leading up to H2-2019 which marks the period when pipelines are expected to come online and help alleviate the sizeable discount for crude produced in the Permian Basin. This should help U.S. production growth and, consequently, act as resistance on prices down the road.