# Higher for Longer

## Highlights

- U.S. equities reached new all-time highs in September, just as we marked the 10th year anniversary of the GFC, reinforcing scepticism about the sustainability of the so-called “longest bull run in history.” In this regard, a rather simple analysis of secular bull markets suggests that investors should perhaps welcome new highs with some optimism, not scepticism.
- Although the latest tariff announcements were relatively well received by market participants, the US-China trade outlook remains challenging, to say the least.
- At home, market action on this first day following a tentative agreement between the U.S., Mexico, and Canada seems to confirm what we advanced last month – namely that the impact of a potential deal would mainly be mirrored in the rates/FX space, not in outperformance from Canadian equities. Under these circumstances, we keep our geographical allocation unchanged. As such, we continue to favour U.S. equities, yet we recognize the growing list of cost pressures which could become headwinds for the latter in 2019.
- The possibility of short-term retreats in bond yields cannot be ruled out should risk asset volatility pick up. However, there is reason to believe the upward trend in interest rates will persist over the next quarter. We, therefore, keep our allocation in favour of stocks over bonds unchanged.
- The Federal Reserve removal of the word “accommodative” from its latest monetary policy statement is not worrying. After all, the Central Bank policy rate adjusted for core inflation (i.e. real rate) has just turned positive for the first time in 10 years. There also appears to be room to the upside for rates as market participants are not yet pricing-in what the majority of Fed officials expect for 2019: at least three rate hikes following another lift in December this year.
- Our side of the border, there is little doubt that the Bank of Canada will raise rates at its October 24th meeting, especially now that an agreement was reached on NAFTA.
- In commodities, we still expect energy levels to slowly appreciate by year-end as the supply-and-demand picture doesn’t seem to have changed much and because OPEC+Russia are committed to maintain some form of stability. However, some shifts in production, such as lower-than-expected output from Venezuela and Iran have skewed potential returns on the positive side, should additional unplanned outages occur.

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

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

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

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

## Market Review

**Fixed Income**

- Fixed-income indices finished lower in September, with U.S. 10-year rates breaking above the 3% mark for the first time since May 2018.
- On the monetary policy front, the U.S. Federal Reserve hiked its policy rate for a third time this year, bringing it above core inflation for the first time in 10 years.
- Canadian 10-year rates also climbed higher last month, without breaking above their 2018 high of 2.5%, however.

**Canadian Equities**

- Despite marijuana stocks pushing the healthcare sector up by an impressive 12.2% this month, the S&P/TSX delivered its second negative performance in a row and its worst monthly return since February as NAFTA negotiations extended throughout the month.
- The energy sector failed to benefit from crude oil's new highs, as production in Western Canada remains landlocked.

**U.S. Equities**

- The S&P 500 fared better than both Canadian and emerging markets equities in September, finishing positive for a 6th consecutive month as investors' risk appetite improved somewhat.
- This brings the index up a solid 7.7% (5.8% in Canadian dollars) in the third quarter, well ahead of all its peers.
- Sector-wise, only materials and consumer staples remain negative year-to-date.

**Commodities**

- WTI oil prices reacted favourably to a 'no-change' in OPEC production output from the Algiers meeting as the supply-and-demand picture continues to tighten.
- Gold was unable to take advantage of the commodity market uptick in September, as prices couldn't break their 50-day moving average and concerns remain over emerging market demand.

**Foreign Exchange**

- The Loonie got a last-minute lift at the end of the month from better-than-expected GDP numbers and BoC Governor Stephen Poloz taking a hawkish tone. However NAFTA negotiations continued to loom large as any headline on the matter materially increased intra-day volatility.
- Despite the trade war heating up and Brexit negotiations faltering, the U.S. dollar index volatility remains subdued as prices stayed within a 2% band for the whole month.

**Table 2 Market Returns**

| Asset classes | September | Q3 | YTD |
|---|---|---|---|
| **Cash (3-month T-bills )** | 0.1% | 0.3% | 0.9% |
| **Bonds (FTSE/TMX Ovr. Univ.)** | **-1.0%** | **-1.0%** | **-0.4%** |
| FTSE/TMX Short term | -0.2% | 0.0% | 0.5% |
| FTSE/TMX Mid term | -0.9% | -0.8% | -0.5% |
| FTSE/TMX Long term | -2.1% | -2.4% | -1.5% |
| FTSE/TMX Government | -1.0% | -1.2% | -0.6% |
| Federal | -0.8% | -0.8% | -0.2% |
| Provincial | -1.3% | -1.5% | -1.0% |
| Municipal | -1.1% | -1.3% | -0.7% |
| FTSE/TMX Corporate | -0.8% | -0.5% | 0.2% |
| AA+ | -0.3% | 0.1% | 0.5% |
| A | -1.2% | -1.1% | -0.5% |
| BBB | -0.8% | -0.4% | 0.6% |
| BoAML High-Yield (USD) | 0.5% | 2.4% | 2.5% |
| Preferred Shares | -0.3% | 1.6% | 2.3% |
| **Canadian Equities (S&P/TSX)** | **-0.9%** | **-0.6%** | **1.4%** |
| Energy | -3.2% | -5.7% | -1.2% |
| Industrials | 0.2% | 5.6% | 12.6% |
| Financials | -0.1% | 3.8% | 2.2% |
| Materials | -1.3% | -12.9% | -10.1% |
| Utilities | -1.8% | -1.6% | -7.8% |
| Cons. Disc | -4.4% | -8.0% | -4.7% |
| Cons. Staples | -0.1% | -0.9% | -3.5% |
| Healthcare | 12.2% | 31.4% | 29.9% |
| IT | 0.1% | 3.0% | 26.0% |
| Telecom | -0.5% | 2.4% | -2.7% |
| REITs | -0.5% | 3.9% | 9.3% |
| S&P/TSX Small Cap | -1.3% | -2.8% | -4.4% |
| **US Equities (S&P500 USD)** | **0.6%** | **7.7%** | **10.6%** |
| Energy | 2.6% | 0.6% | 7.5% |
| Industrials | 2.2% | 10.0% | 4.8% |
| Financials | -2.2% | 4.4% | 0.1% |
| Materials | -2.1% | 0.4% | -2.7% |
| Utilities | -0.6% | 2.4% | 2.7% |
| Cons. Disc | 1.0% | 8.2% | 20.6% |
| Cons. Staples | 1.0% | 5.7% | -3.3% |
| Healthcare | 2.9% | 14.5% | 16.6% |
| IT | -0.3% | 8.8% | 20.6% |
| Telecom | 4.3% | 9.9% | 0.8% |
| REITs | -2.6% | 0.9% | 1.7% |
| Russell 2000 (USD) | -2.5% | 3.3% | 10.5% |
| **World eq. (MSCI ACWI)** | **0.5%** | **4.4%** | **4.3%** |
| MSCI EAFE (USD) | 0.9% | 1.4% | -1.0% |
| MSCI EM (USD) | -0.5% | -0.9% | -7.4% |
| **Commodities (CRB index)** | **1.2%** | **-5.1%** | **-3.7%** |
| WTI Oil (US$/barrel) | 4.8% | -1.3% | 21.0% |
| Gold (US$/ounce) | -0.9% | -4.8% | -8.6% |
| Copper (US$/tonne) | 5.0% | -5.5% | -13.1% |
| **Forex (DXY - US Dollar index)** | **0.0%** | **0.5%** | **3.3%** |
| USD per EUR | -0.2% | -0.5% | -3.3% |
| CAD per USD | -1.0% | -1.7% | 2.6% |

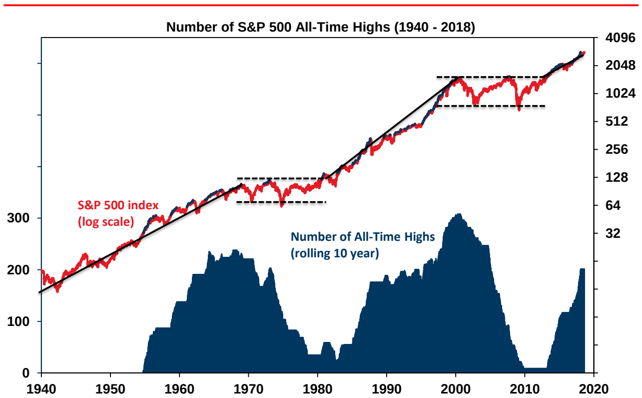
Source: Datastream 9/28/2018

## Equities: The Good, the Bad, and the Ugly

U.S. equities reached new all-time highs in September, just as we marked the 10th year anniversary of the *Great Financial Crisis*, reinforcing scepticism about the sustainability of the so-called "longest bull run in history."

In this context, we believe it is important to look at the long-term picture and recall the difference between cyclical and secular bull markets. By generally accepted definition, a downturn of more than 20% marks the end of a cyclical upswing, and U.S. stocks haven't had one in nearly 10 years. As overdone as this market may seem, it should not be forgotten that the S&P 500 only broke away from a 16-year-long secular range-bound in 2013. In this regard, a rather simple analysis counting the number of all-time highs reached over a rolling 10-year window since the 1940s highlights surprisingly well the previous two secular bull markets. It also suggests that investors should perhaps welcome new highs with some optimism, not scepticism (**Chart 1**).

**1 A secular bull market in the making?**



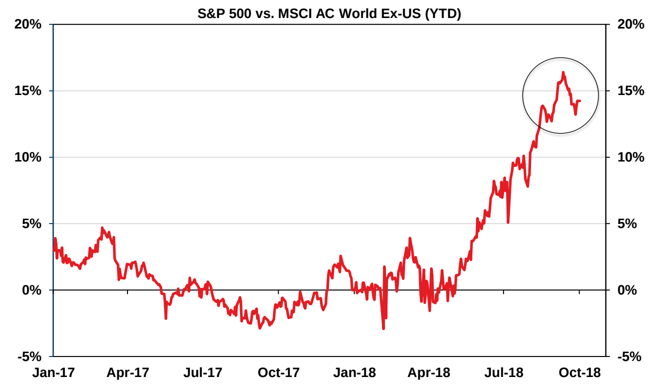

Source: Datastream

With that being said, it's not U.S. but rather international equities that have suffered the most from investors' pessimism in this year of trade disputes and tariffs threats. That trend has, however, modestly eased over the last weeks after President Trump announced lower than feared (10% vs. 25%) tariffs on an additional $200 billion worth of Chinese imports (**Chart 2**).

Although the latest tariff announcements were relatively well received by market participants, the US-China trade outlook remains challenging, to say the least. Trump's administration is set to increase the tariff rate to 25% in January if no agreement is reached. China points to non-tariff measures to disrupt supply chains of American companies, and the U.S. administration has threatened to slap tariffs on an additional $267bn of Chinese imports should China retaliate.

At home, after over a year of tense negotiations, headline threats and uncertainty appears mostly over as Canada and the

**2 Brief pause in quasi-linear US equities dominance…**




Source: Datastream

U.S. finally reached an agreement regarding the NAFTA replacement, now to be named USMCA (United States-Mexico-Canada Agreement). While most of what was in the U.S.-Mexico deal is included in this new document, the preliminary details highlight that Canada has made concessions regarding a sunset clause, a cap on auto exports to the U.S. and better access for U.S. farmers to the Canadian dairy market. In return, Chapter 19 is preserved (impartial arbitration panel) and protection for Canadian cultural industries are retained.

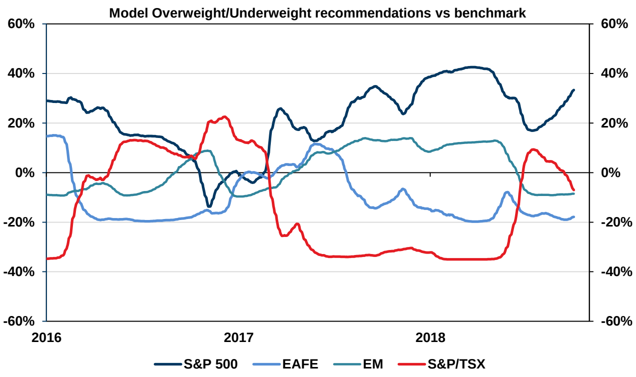
Last month, we advanced that "*barring a sharp rally in commodity prices, upside potential seems limited vs. the U.S. Just as episodes of tense trade negotiations saw the S&P/TSX stand relatively strong, we believe the impact of a potential deal among Canada, Mexico, and the U.S. will mainly be mirrored in the rates/FX space*". As of this writing, market action on this first day under the USMCA (Canadian dollar +0.9%, Canadian 10-year rates +8bp, S&P/TSX +0.09%, S&P 500 +0.40%) seems to be proving us right.

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 the U.S. stocks to continue to benefit from a stronger economic backdrop, and prefer not to "front run" our relative momentum model (**Chart 3**, next page).

Yet, we recognize the growing list of cost pressures (rising wages, transportation costs, U.S. dollar, tariffs) which could become headwinds in 2019. For instance, favourable base effects for U.S. corporate earnings growth (largely due to tax cuts) are gradually fading, with expectations for the next twelve months now at par with emerging markets and Canadian equities (**Chart 4**, next page).

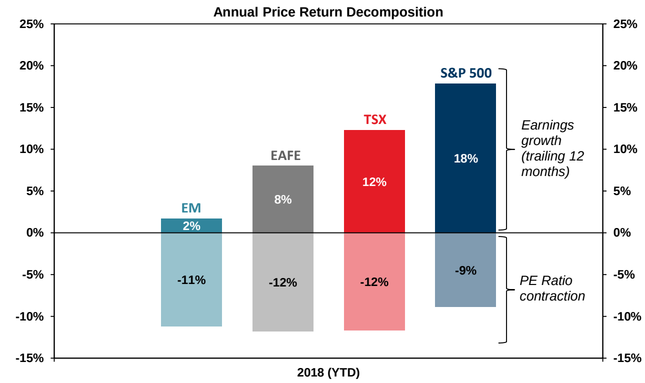
What's more, if the U.S. were to tax all imports from China, it would undeniably result in a drop in expected EPS for the S&P 500, not to mention the high probability of non-tariff

### 3 …but relative momentum still in their favour



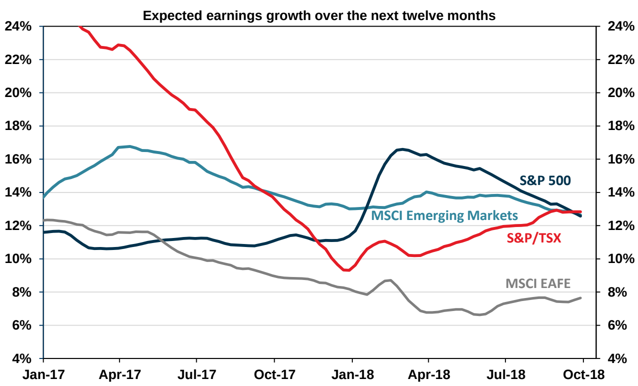

Source: Datastream
**Benchmark = 35% S&P 500, 35% S&P/TSX, 20% MSCI EAFE, 10% MSCI EM**

### 5 It's all about earnings!



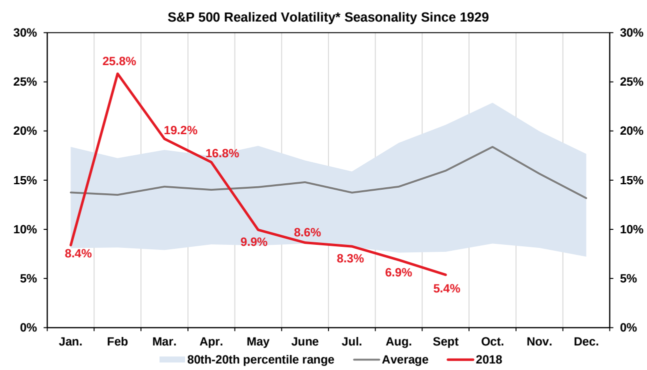

Source: Datastream

### 4 Favourable base effects gradually fading in the U.S.




Source: Datastream. Expected earnings growth = forward 12-month earnings expectations divided by trailing 12-months realized earnings (IBES data).

### 6 October: The perfect stage for mean reversion?




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

measures by the Chinese government that would follow. To be clear, our base case scenario remains one where the world's two biggest economies will avoid derailing one another and come to terms. But, we shall not underestimate the risks posed to the global earnings backdrop and, in turn, geographical leadership.

As we've mentioned earlier this year, corporate earnings are of paramount importance at this stage of the cycle. Case in point: they alone explain much of the geographical divergence in 2018, as all indices experienced similar ratio contraction (**Chart 5**).

Finally, 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 (**Chart 6**).

Still, 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. We, therefore, keep our allocation in favour of stocks over bonds unchanged.

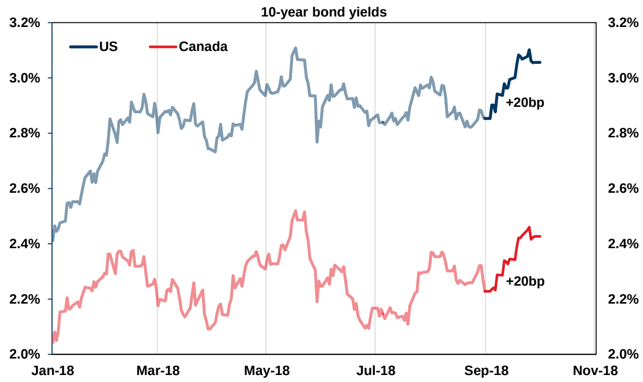
## Fixed Income: For Real?

Last month, we stated that "*with 10-year bond yields having gone nowhere over the last few months, despite rising inflation, stellar economic growth, and rate hikes, perspectives for fixed-income assets continue to resemble an insurance policy against global risk aversion more than attractive alternatives to equities, in our view."*

In this regard, U.S. and Canadian government bond yields effectively climbed back up in September (**Chart 7**, next page) as investors' increased appetite for risk led to an extension of losses for fixed-income benchmarks (**Chart 8**, next page).

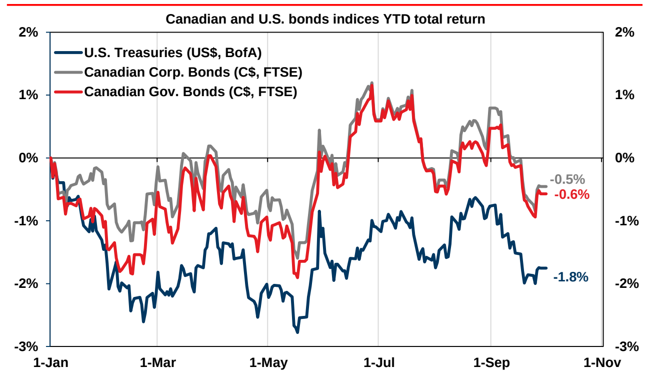
Bond yields obviously don't move in a straight line, and the possibility of short-term retreats cannot be ruled out should risk assets volatility pick up. However, there is reason to believe that the upward trend in interest rates will persist over the next quarter.

### 7 Higher risk appetite led to higher bond yields…



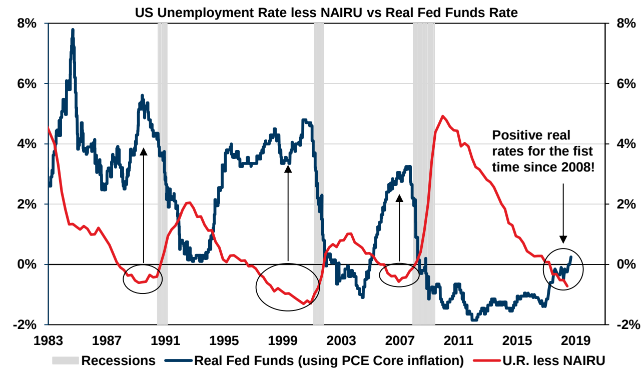

Source: Datastream

### 8 … and losses for fixed income benchmarks



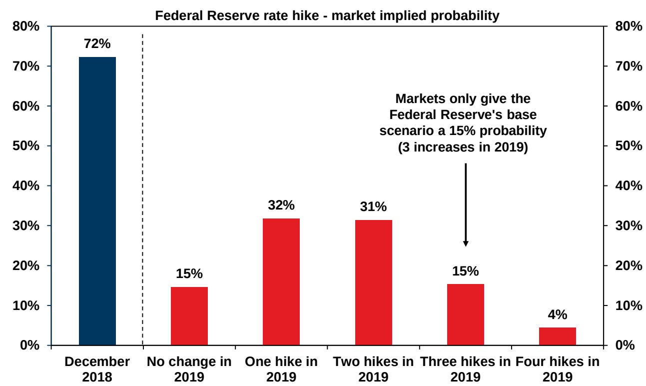

Source: Datastream

### 9 US monetary policy certainly doesn't look restrictive




Source: Datastream. Real Fed Funds = Fed funds rate upper target less PCE Core inflation YoY. NAIRU = Non-accelerating inflation rate of unemployment (estimated level of unemployment below which inflation rises).

### 10 The market does not believe the Fed… for now




Source: Bloomberg. 2019 market probabilities suppose that the Fed will hike interest rates in December 2018.

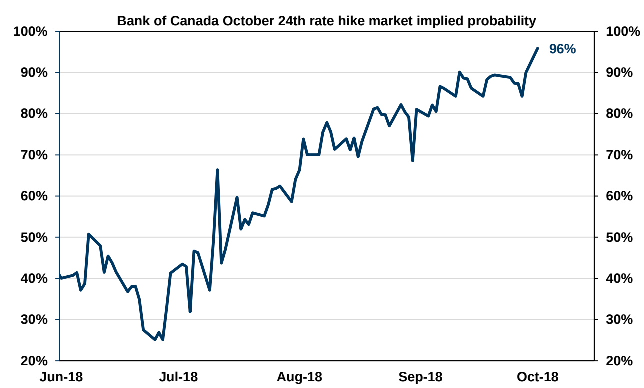
For one, despite the Federal Reserve having removed the word "accommodative" from its latest monetary policy statement, Fed Chair Jay Powell insisted that it did not signal any change in plans, and even added that, in practice, they still viewed policy as accommodative. After all, the Central Bank policy rate adjusted for core inflation (i.e. real rate) has just turned positive for the first time in 10 years – an observation all the more overdue, considering the buoyant labour market conditions (**Chart 9**).

For another, there appears to be room to the upside as market participants are not yet pricing-in what the majority of the Fed officials expects for 2019: at least three rate hikes following another lift in December of this year (**Chart 10**).

Our side of the border, there is little doubt that the Bank of Canada will raise rates at its October 24th meeting, especially now that an agreement was reached on NAFTA (**Chart 11**).

Thereafter, further interest rate increases are also to be expected now that the main obstacle to monetary policy

### 11 A Bank of Canada rate hike in October is in the bag




Source: Bloomberg

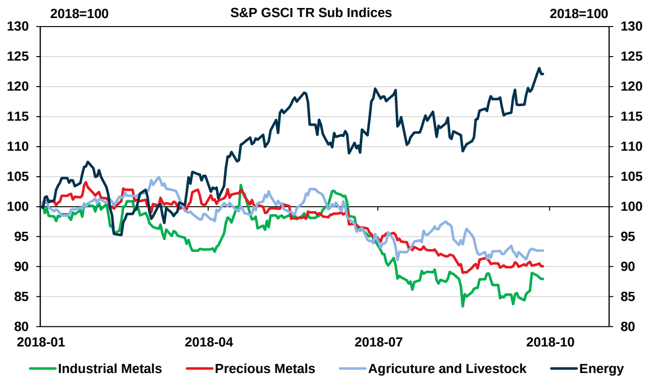
normalization is gone. According to National Bank's Economics & Strategy, this should lead to three rate hikes in 2019.

## Commodities: Will OPEC's Capacity Be Put to the Test?

While equities seem undeterred by political winds, commodities (particularly metals and agricultural products) have been the poster boy of trade war rhetoric and/or fear about China's economic growth. While it's undeniable that the country and emerging markets overall have outsized influences on incremental demand for commodities, not all products are equal in facing those types of risks.

For example, crude oil seems little affected by recent news, as it is considered more of a consumer demand product and a mature global market than base metals which have the tendency to be tied to infrastructure spending (**Chart 12**).

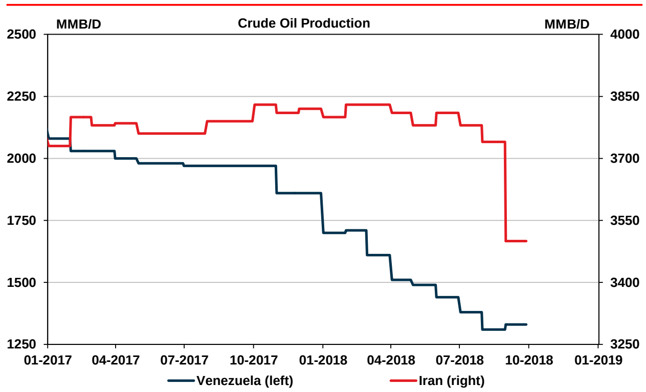
**12 Energy commodities are in a class of their own**




Source: Datastream

In fact, energy markets seem to have gone through a transition – from oversupply in 2014 and 2015 to an artificially balanced market via OPEC+Russia cuts in 2016 and 2017 to upside risks from unplanned outages now. Iran's activity has decreased faster than expected in anticipation of U.S. sanctions coming online November 5th and Venezuela output continues to decrease (**Chart 13**). Consequently, the call on OPEC to increase production is becoming more and more intense. Despite tightening markets, the no-change in policy from the meeting in Algiers between the Cartel and its partners has only added to the bullish sentiment.

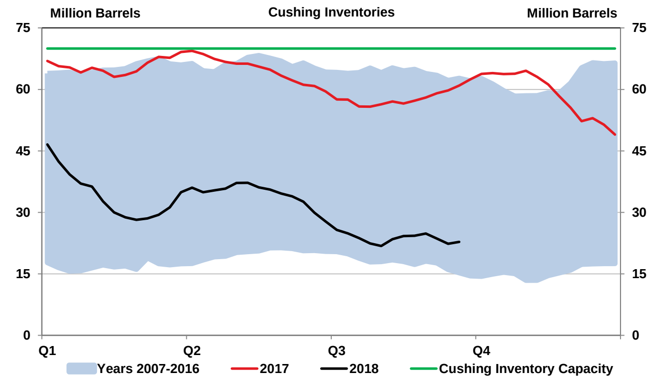
**13 The call on OPEC's spare capacity is intensifying**




Source: Bloomberg

While the Cartel and Russia restated their confidence in their ability to cover for future demand requirements, markets fear they will be late to react. There is also potential for additional disruptions in Nigeria or Libya which could overwhelm that spare capacity. Adding those risks to the lower inventories (**Chart 14**) is a perfect cocktail for a spike in prices if any surprises occur on those fronts.

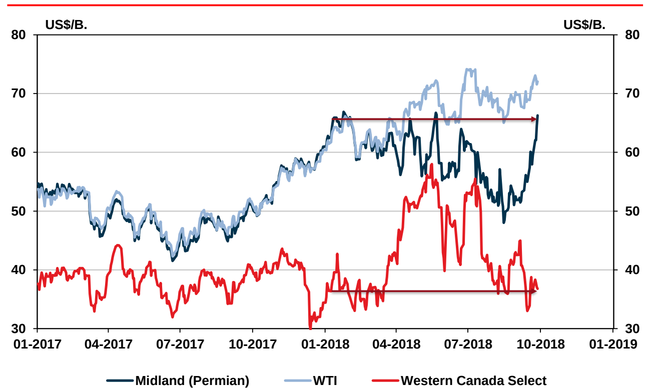
**14 As inventories decrease, the upside risks increase**




Source: Datastream

What about production in the U.S. and Canada? Their output is still landlocked due to transportation bottlenecks which depresses local prices and margins (**Chart 15**). Until some pipelines come online in the first half of 2019, the potential for acceleration of activity remains unlikely (**Chart 16**, next page).

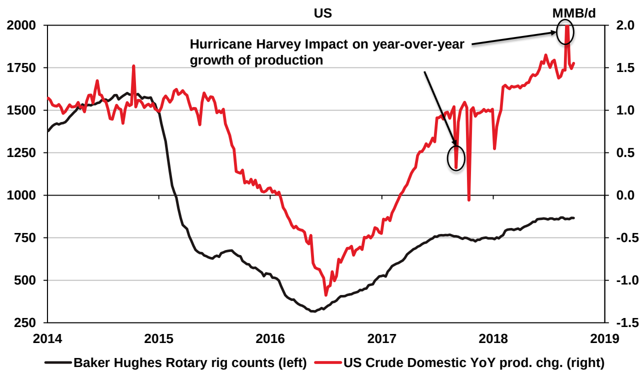
**15 Unchanged local crude prices …**




Source: Bloomberg

In conclusion, we still expect energy prices to slowly appreciate by year-end as the supply-and-demand picture doesn't seem to have changed much and OPEC+Russia are committed to maintaining some form of stability. However, some shifts in production, such as lower-than-expected output from Venezuela and Iran have skewed potential returns on the positive side should additional unplanned outages occur.

16 ... have an impact on production growth



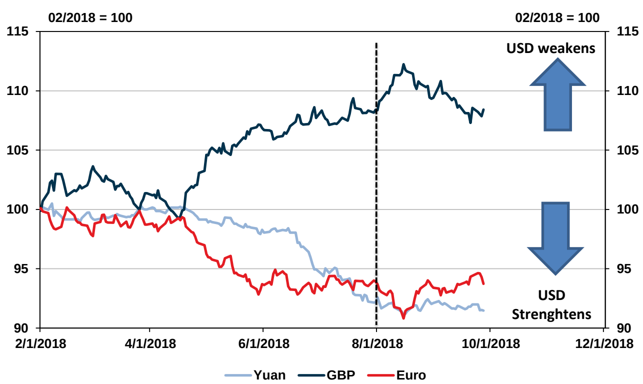

Source: Datastream

## Currencies: NAFTA is Dead... Long Live USMCA!

What does the USMCA mean for the Loonie going forward? As we said in the fixed income section, most of the factors which could have restrained the BoC from hiking in light of increasing inflation are gone. Consequently, our view that the loonie will appreciate by year-end remains intact, but the potential outcomes are much less volatile now that the sword of Damocles is removed.

On the world stage, despite trade tensions with China ramping up and Brexit negotiations taking a turn for the worse, major currencies are still roughly at the same levels witnessed at the beginning of August (**Chart 17**).

17 Recent turmoil has had little impact on fx values




Source: Datastream

While the reduced volatility for the U.S. dollar is surprising in light of the turmoil, some form of progress is being made on the monetary policy front. ECB President Mario Draghi highlighted his confidence that the tightening labour market will push up wage growth with inflation hitting its target in the years ahead. These comments have signalled to markets that the ECB would probably end the expansion of its QE program at the end of 2018.

On the U.S. side, the Fed is staying the course. The last statement following the hike in September contained very few surprises. One last hike is expected by the end of the year plus three in 2019. As a consequence, our medium-term view remains the same. We still expect the Greenback to weaken, barring any surprises that would push either the ECB or the Fed to change their approaches.