NATIONAL BANK

ASSET ALLOCATION STRATEGY

September 4, 2018

America First

Highlights

- Despite political drama out of Washington, one can hardly deny that macroeconomic conditions have rarely been this good south of the border. Jobless claims are at their lowest point since the late 60s, monthly job creation has averaged +200k over the last year. Additionally, consumer confidence is at an 18-year high, the manufacturing PMI jumped to 61.3 this morning (best in 14 years), and the latest GDP figures showed the strongest reading in nearly 4 years – easily eclipsing all G7 peers
- With North America nearing a trade agreement, cautious monetary policy normalization by the Federal Reserve, and equity valuations comparing increasingly well to fixed income, we've decided to marginally augment our cyclical exposure by swapping a fraction of bonds for stocks. We're also taking some profits on our North American allocation by bringing the S&P/TSX back to neutral and downsizing our EAFE underweight.
- Government bond yields have essentially gone nowhere over the last few months despite rising inflation, stellar economic growth, and rate hikes. Under these circumstances, perspectives for fixed-income assets continue to resemble an insurance policy against global risk aversion more than an attractive alternative to equities, in our view.
- The potential conclusion of trade-related uncertainties should allow the loonie to move closer to levels consistent with current oil prices, inflation, and economic surprises. Still, we choose to act with caution, starting with a slight C$ overweight, and we will reassess as the trade situation becomes clearer.
- Political risks aside, the fundamental outlook for crude oil remains healthy, as inventory normalization should continue for the rest of 2018.
- We are sticking to our overweight U.S. equity stance. Technology giants have undoubtedly largely contributed to the S&P 500 dominance this year, but that doesn't mean market breadth is weak. All sectors have delivered positive earnings growth in Q2-2018, with 9 out of 11 in the double-digit range.
- After a 20% downturn in emerging market equities, we've also discussed a potential return to a tactical overweight, but concluded that prudence and patience were still appropriate.

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 August fractionally higher, with U.S. 10-year rates stuck in a relatively narrow range of 2.80% to 3.00% for most of the last 3 months.
- Canadian 10-year rates exhibited higher volatility, especially in the last few days of the month as the announcement of a new U.S.-Mexico trade deal brought Canada back into the spotlight. They now stand at 2.23%, 8 bp lower than a month earlier.

Canadian Equities

- The S&P/TSX delivered its first negative monthly performance since March 2018 as Canadian government officials signalled that a final agreement on trade would not be reached within the deadline set by the U.S. administration.
- Mounting trade tensions between the U.S. and China weighed heavily on materials stocks, while the overturn by the Federal Court of Appeal of the Trans Mountain oil pipeline expansion dragged the energy sector lower.

U.S. Equities

- The S&P 500 outperformed global equities yet again in August, reaching a new all-time high, while breaking the record for the longest bull market in history.
- The index got a lift from another stellar earnings season, with all sectors but one contributing positively to the performance.

Commodities

- WTI oil prices concluded August where they started, with the threat posed by a growing U.S.-China trade spat offset by a larger-than-expected decline in U.S. crude stockpiles.
- Gold prices managed to settle just above 1200$/oz. after falling as low as 1160$/oz., its lowest since January 2017, as it faced pressure from a rising U.S. dollar and broad-based short selling.

Foreign Exchange

- The Loonie got a temporary lift from rising prospects of a revamped NAFTA deal, but converged back to 0.77 U.S.$ per C$ as Q2-2018 GDP marginally missed expectations.
- After rallying extensively in the first half of August, the U.S. dollar index reversed course but still closed on a stronger note, supported by higher risk aversion amid uncertainty over the outlook for global trade.

Table 2 Market Returns

Asset classes	August	YTD	2017
Cash (3-month T-bills)	0.1%	0.8%	0.6%
Bonds (FTSE/TMX Ovr. Univ.)	**0.8%**	**0.6%**	**2.5%**
FTSE/TMX Short term	0.3%	0.7%	0.1%
FTSE/TMX Mid term	0.8%	0.4%	1.0%
FTSE/TMX Long term	1.3%	0.5%	7.0%
FTSE/TMX Government	0.7%	0.5%	2.2%
Federal	0.6%	0.7%	0.1%
Provincial	0.8%	0.2%	4.3%
Municipal	0.8%	0.5%	4.7%
FTSE/TMX Corporate	0.8%	1.0%	3.4%
AA+	0.6%	0.8%	0.7%
A	1.0%	0.8%	4.4%
BBB	0.9%	1.3%	4.0%
BoAML High-Yield (USD)	0.7%	1.9%	7.5%
Preferred Shares	0.8%	2.7%	13.6%
Canadian Equities (S&P/TSX)	**-0.8%**	**2.3%**	**9.1%**
Energy	-3.6%	2.1%	-7.0%
Industrials	0.7%	12.4%	19.7%
Financials	1.2%	2.3%	13.3%
Materials	-8.2%	-8.9%	7.7%
Utilities	-0.7%	-6.1%	10.8%
Cons. Disc	-3.5%	-0.3%	22.8%
Cons. Staples	-1.7%	-3.4%	7.8%
Healthcare	28.4%	15.8%	34.2%
IT	5.1%	25.9%	16.8%
Telecom	-0.9%	-2.2%	14.8%
REITs	2.4%	9.9%	11.2%
S&P/TSX Small Cap	-0.5%	-3.1%	2.8%
US Equities (S&P500 USD)	**3.3%**	**9.9%**	**21.8%**
Energy	-3.3%	4.8%	-1.0%
Industrials	0.3%	2.6%	21.0%
Financials	1.4%	2.4%	22.2%
Materials	-0.5%	-0.7%	23.8%
Utilities	1.1%	3.3%	12.1%
Cons. Disc	5.1%	19.4%	23.0%
Cons. Staples	0.5%	-4.3%	13.5%
Healthcare	4.4%	13.3%	22.1%
IT	6.9%	21.0%	38.8%
Telecom	3.0%	-3.4%	-1.3%
REITs	2.5%	4.4%	10.8%
Russell 2000 (USD)	4.2%	13.4%	13.1%
World eq. (MSCI ACWI)	**0.8%**	**3.8%**	**24.6%**
MSCI EAFE (USD)	-1.9%	-1.9%	25.6%
MSCI EM (USD)	-2.7%	-6.9%	37.8%
Commodities (CRB index)	**-4.8%**	**-4.9%**	**2.2%**
WTI Oil (US$/barrel)	-0.1%	15.5%	12.5%
Gold (US$/ounce)	-1.6%	-7.7%	12.6%
Copper (US$/tonne)	-5.0%	-17.2%	30.5%
Forex (DXY - US Dollar index)	**0.7%**	**3.3%**	**-9.9%**
USD per EUR	-0.6%	-3.1%	13.8%
CAD per USD	0.2%	3.7%	-6.4%

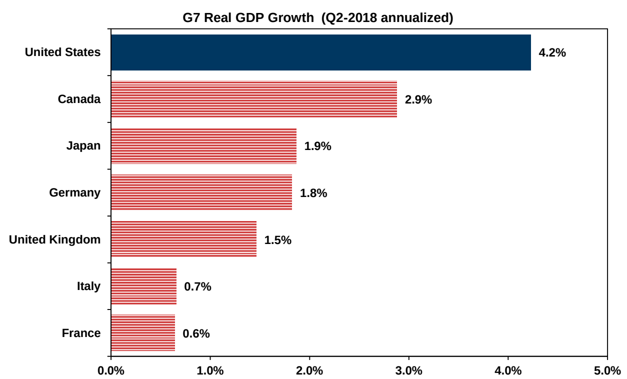
Source: Datastream 8/31/2018

America First

Political drama *Made in America* certainly didn't take a vacation this summer. Over the last few weeks, the U.S. administration imposed tariffs on an additional $16 billion worth of trade in goods between the U.S. and China, threatened to bring that number up by $200 billion, rubbed salt in Turkey's wounds, and saw the President's long-time lawyer plead guilty to criminal charges just as his former campaign manager was convicted of fraud… among other things.

Nevertheless, one can hardly deny that macroeconomic conditions have rarely been this good south of the border. Jobless claims are at their lowest point since the late 60s, monthly job creation has averaged +200k over the last year. Additionally, consumer confidence is at an 18-year high, the manufacturing PMI jumped to 61.3 this morning (best in 14 years), and the latest GDP figures showed the strongest reading in nearly 4 years – easily eclipsing all G7 peers (**Chart 1**).

1 American GDP growth is eclipsing all G7 peers…



Source: Datastream

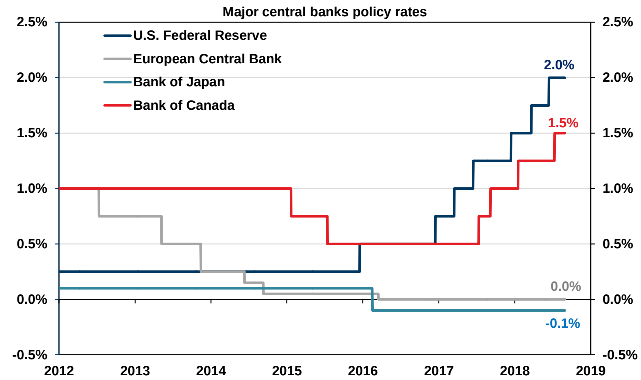
In parallel, typical late-cycle symptoms such as rising volatility, commodity prices, and rates have succeeded one another this year. Let's reiterate that such an environment does not hinder risk assets outperformance. Recessions are the real threat, and it is simply not the signal sent by U.S. macro figures.

With an economy running at full steam and inflation trending higher, we should not be surprised with the Federal Reserve commitment to gradually bring rates from accommodative to neutral, notwithstanding other central banks' stances (**Chart 2**).

As not all countries enjoy the same economic conjuncture – whether it be because of cyclical factors or uncertainties stemming from erratic U.S. trade initiatives – virtually all currencies have suffered a decline in their value against the U.S. dollar over the last 6 months (**Chart 3**).

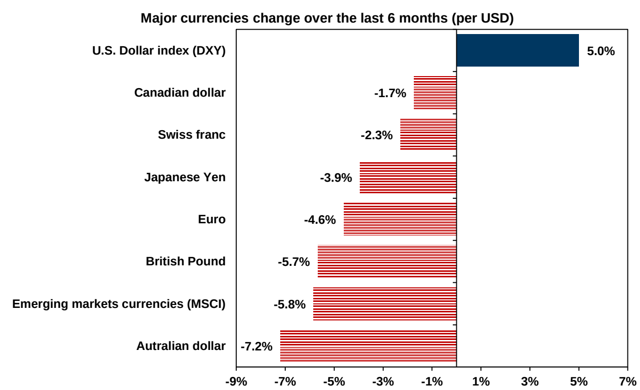
It is in these circumstances that we've seen U.S. equities completely dominate the race for the top-performing region so far in 2018, especially when measured in Canadian dollars, while bonds have essentially gone nowhere (**Chart 4**).

2 … comforting the FED in its normalization process …



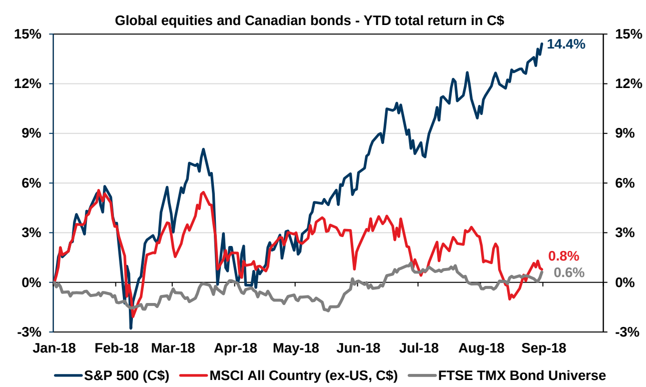
Source: Datastream

3 … and keeping king dollar on its throne …



Source: Datastream; From February 28th to August 31st, 2018.

4 … as US equities dominate the race so far in 2018



Source: Datastream

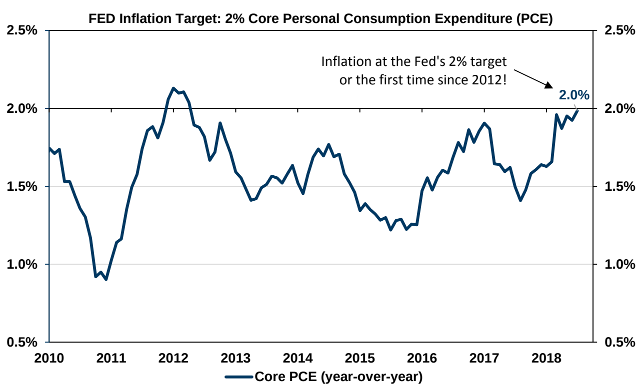
Back in June, faced with the rapid escalation of trade tensions and symptoms of an aging business cycle, we chose to add another notch of caution to our allocation by modestly downsizing our overweight equity stance and favouring North American stocks over their international alternatives.

Two months later, the business cycle is obviously not getting any younger, but with North America nearing a trade agreement, cautious monetary policy normalization by the Federal Reserve, and equity valuations comparing increasingly well to fixed income, we've decided to marginally augment our cyclical exposure by swapping a fraction of bonds for stocks. We're also taking some profits on our North American allocation by bringing the S&P/TSX back to neutral and downsizing our EAFE underweight.

Fixed Income: Cautious Central Bankers

Monetary policy normalization poses a risk of accelerating in the context of an economy running above potential and with inflation now at the Fed's 2% target (**Chart 5**).

5 Inflation right on the Fed's 2% target



Source: Datastream

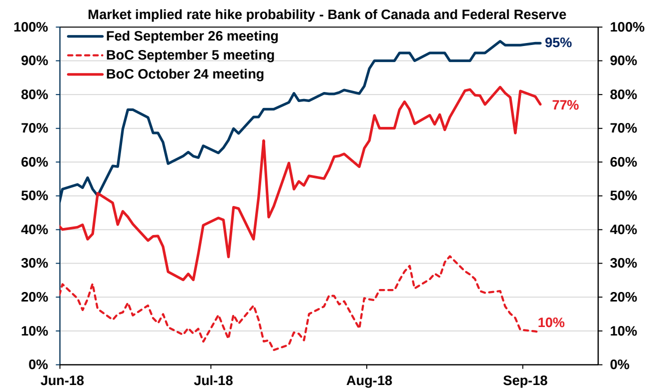
However, recent remarks by Federal Reserve Governor Jerome Powell at the annual Jackson Hole symposium for central bankers were particularly reassuring with regard to the pace at which he intends to bring policy rates higher. Speaking of "Monetary Policy in a Changing Economy", he emphasized the uncertainty surrounding their estimates of the natural rate of unemployment, potential output growth, and the neutral interest rate – all of which argue in favour of a prudent approach to monetary policy perhaps more than ever before.

Bank of Canada Governor Poloz argued in the same vein the following day, suggesting that potential economic output is perhaps higher than central bankers believe because of under-appreciated rates of technological change.

We believe this suggests central banks will continue to act with great prudence, gradually and cautiously bringing monetary policy from accommodative to neutral without overemphasizing any particular data points, and communicating their intentions as best they can.

For now, markets are fairly confident that the Fed is going to announce a hike at its September 26 meeting and the Bank of Canada will wait for October 24 to do likewise (**Chart 6**).

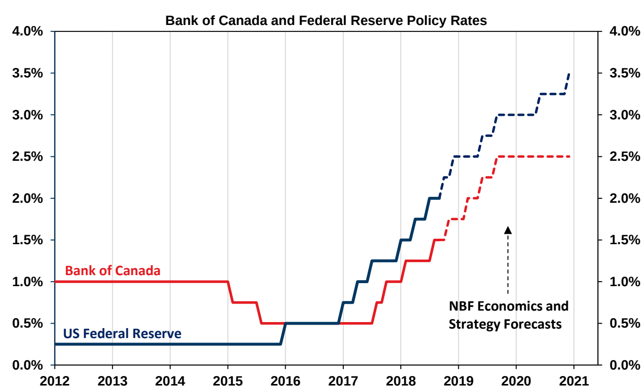
6 Central banks set to hike in the coming months…



Source: Bloomberg

Beyond that, NBF Economics and Strategy expects the Fed Funds' rate to increase once more before year-end, and twice in each of 2019 and 2020. In Canada, the Central Bank is expected to hold on after 3 hikes next year (**Chart 7**).

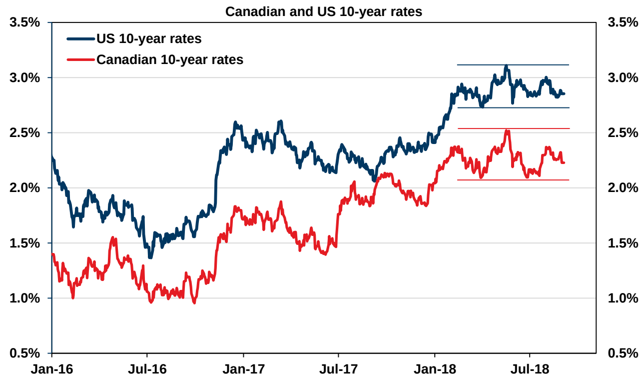
7 …and to continue beyond 2018



Source: Datastream. NBF Economics and Strategy

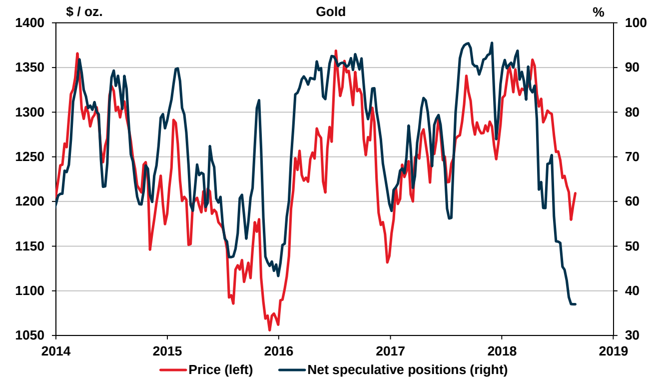
As such, with 10-year bond yields having gone nowhere over the last few months, despite rising inflation, stellar economic growth, and rate hikes, perspectives for fixed-income assets continue to resemble an insurance policy against global risk aversion more than attractive alternatives to equities, in our view (**Chart 8, next page**).

8 10-year rates directionless over the last six months



Source: Datastream.

10 Short positioning has reached levels unseen since 2006



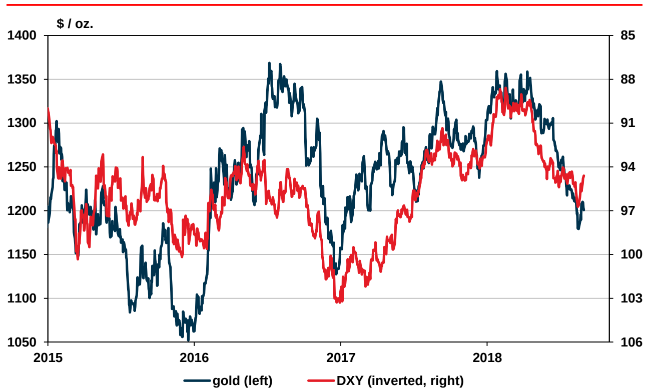
Source: Datastream

Commodities: All That Glitters is Not Gold

Gold is one asset whose performance is tied to recent global developments. For one, demand for the precious metal tends to come from emerging markets, with China as the top consumer. Recent weakness in economic numbers from the country has spooked investors into believing that consumption of gold may be lower than expected, especially when added to the relentless U.S. pressure on the trade front.

Secondly, as we stated above, the fact the U.S. is leading the pack GDP-wise has added some lift to the Greenback which is acting as the main influence on the direction of commodity prices these days (**Chart 9**).

9 USD and gold: two sides of a coin



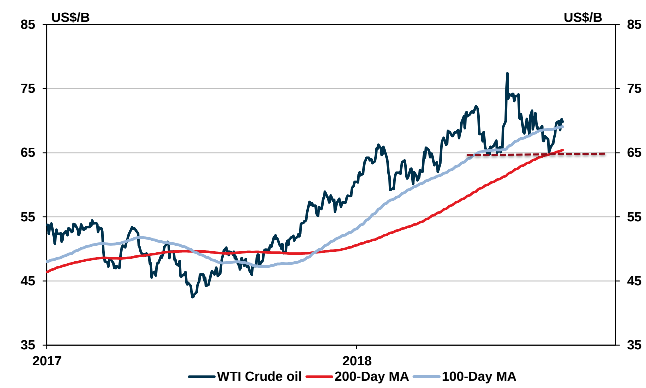
Source: Datastream

In this light, speculators have added to the already-difficult environment by increasing their short positioning (**Chart 10**).

However, in line with our view regarding the Greenback's future direction (see the currencies section) and the potential reversal in speculative positioning, we expect prices to rebound in the next quarters.

For crude oil, the OPEC-induced stability continues despite the recent doubts about emerging-market economic growth (especially China) which have not succeeded in pushing prices below the $65 floor (**Chart 11**).

11 Crude's 65$ support is still holding



Source: Datastream

Political risks aside, the fundamental outlook for the product remains healthy, as inventory normalization should continue for the rest of 2018 (**Chart 12, next page).** However, these projections are subject to wild swings, as the overall balance depends on multiple factors.

For example, Mr. Trump's sanctions on Iran are supposed to start in November, which could eventually translate to a shortfall of millions of barrels per day of supply. But, the effects should be mitigated by a U.S. strategic petroleum release as well as a ramp-up of domestic production in the Permian Basin.

The state of emerging market economies should also have some impact on projected demands. Prices have resisted the recent soft patch well, but further deterioration would increase potential downside probabilities as demand growth would have

12 Markets should be balanced in 2019

Oil World supply and Demand (in MMB/d)							Projected	
Year	2012	2013	2014	2015	2016	2017	*2018*	*2019*
OECD Supply	22.5	23.7	25.8	26.8	26.5	27.4	*29.4*	*31.2*
ex-OECD Supply	68.2	67.5	68.0	69.8	70.6	70.5	*70.4*	*70.7*
World Supply	90.8	91.3	93.8	96.7	97.1	97.9	*99.8*	*101.9*
OECD Demand	45.9	46.0	45.6	46.3	46.7	47.2	*47.7*	*48.1*
ex-OECD Demand	44.5	46.2	48.0	49.1	50.1	51.3	*52.6*	*53.9*
World Demand	90.4	92.2	93.6	95.4	96.9	98.5	*100.3*	*102.0*
World Surplus / Deficit	0.3	(0.9)	0.2	1.3	0.2	(0.6)	*(0.5)*	*(0.1)*
OPEC Supply	38.0	36.9	37.1	38.5	39.4	39.5	*39.1*	*39.0*
US Supply	11.1	12.4	14.1	15.1	14.8	15.6	*17.6*	*19.0*
China Demand	10.2	11.1	11.6	12.4	12.8	13.3	*13.7*	*14.1*

Source: EIA via Datastream

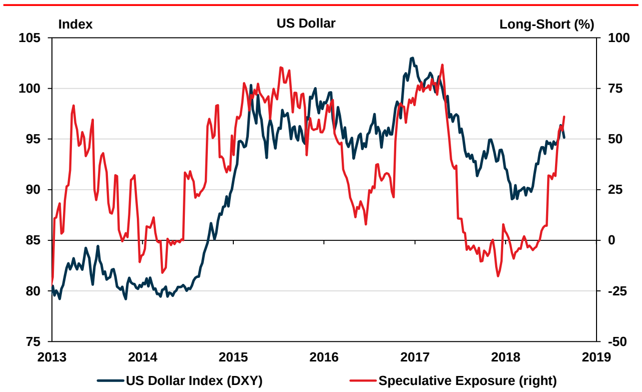
to be revised. Despite all of these scenarios, risks seem fairly balanced for now. And, we expect OPEC to continue its "not-too-hot, but not-to-cold" approach, which should help prices slowly appreciate by year-end.

Currencies: Is the Loonie Prone for a Comeback?

After an uptrend generated by the end of synchronized global growth, the Greenback levels have remained relatively unchanged since the beginning of summer, despite short-term spikes caused by political or emerging market fears.

The effects of monetary policy divergence between the U.S. and the rest of the world, added to Mr. Trump's hawkish rhetoric toward trade with China, have pushed speculators to reverse their short positions, as the Greenback benefits from its properties as a safe-haven asset (**Chart 13**).

13 Strong reversal of short positioning since May



Source: Datastream

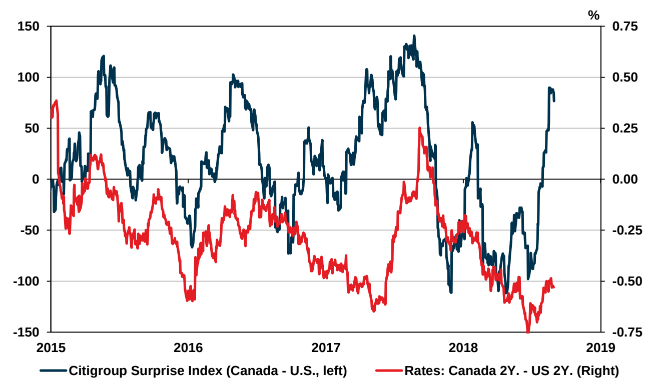
Such long speculative positioning usually spells harder times ahead for the U.S. dollar, and we remain in the camp that the Turkish and Argentinian situations should remain fairly contained.

Consequently, barring any major developments, such as a correction in equity markets or an unexpected deterioration of global economic figures, we expect the Greenback to resume its secular downtrend in the next quarters.

For the Loonie, it's undeniable that the currency has fallen victim to the same pressures as its counterparts have suffered since 2017, as disappointing economic surprises and the NAFTA renegotiations have acted as drags on its performance. However, we believe the worst is behind us and the Canadian dollar should have a clearer path toward appreciation going forward.

Economic surprises have been turning in favour of Canada for a while now, which usually leads to a contraction of yield spreads between Canada and U.S. We have yet to see material movement on that front, but we think we may see a repeat of the beginning of the 2017 scenario where the spread reaction lagged a couple of months behind the turnaround (**Chart 14**).

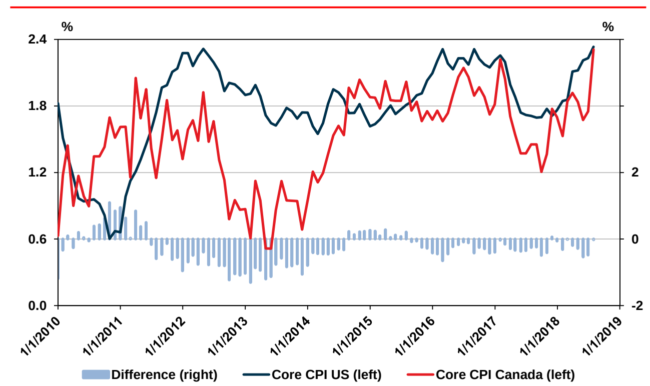
14 Will the 2017 scenario repeat itself?



Source: Datastream

Case in point, inflation has picked up north of the border and it is now only a hair away from that of its neighbour (**Chart 15**).

15 A similar monetary policy ahead for the Fed and BoC



Source: Datastream

In light of this, as we discussed in the fixed-income section, we expect monetary policies between the countries to move in the same direction, starting next quarter.

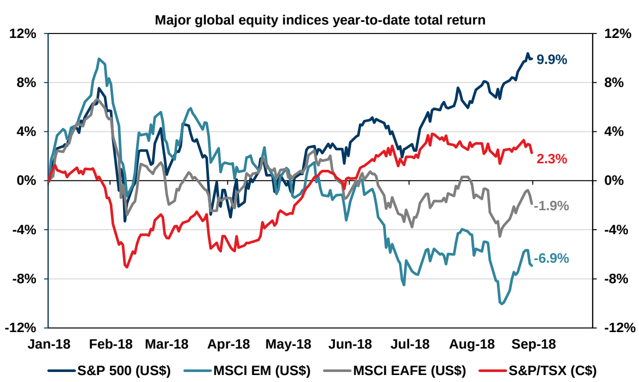
Another factor that should influence the direction of the currency pair is the performance of crude oil, which we believe will appreciate by year-end and act as a support for the Loonie.

All of these positive developments could be overruled by a setback in NAFTA negotiations which still looms large. Despite some renewed optimism on that front, we are playing it safe by suggesting only a small overweight in the Canadian dollar until we get further clarity on that front.

Equities: The Great Divergence

Only time will tell whether U.S. aggressive fiscal stimulus and trade rhetoric will "Make America Great Again" (whatever that means), but it sure made global equity indices diverge again (**Chart 16**). With two thirds of 2018 behind us, the S&P 500 is outpacing emerging markets (EM) by a whopping 16.8%.

16 Make global equities diverge again

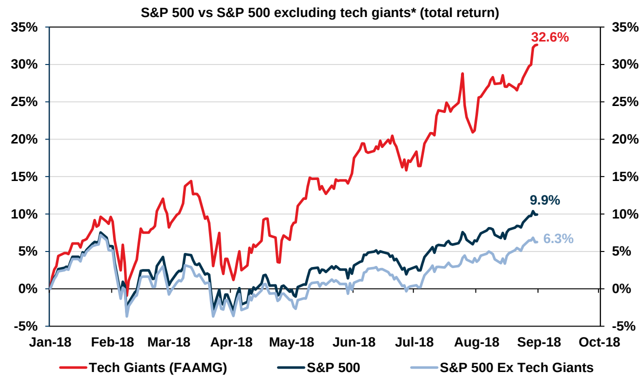


Source: Datastream

An often-cited concern in that regard is that the S&P 500 run-up is only driven by a few tech giants, reflecting poor market breadth and rising idiosyncratic risks. We partially agree. True, FAAMG's (Facebook, Amazon, Apple, Microsoft, Google) dominance is propelling the index higher and, given their combined index weight (17%), any company/sector-specific shock would undoubtedly affect the index. However, just because the Top 5 S&P 500 names are world champions does not necessarily mean the bottom 495 are doing poorly. Case in point, should the FAAMG stocks have been stripped out of the index, the S&P 500 would still be the top-performing index YTD, thanks to a 6.3% total return (**Chart 17**).

What's more, all sectors have delivered positive earnings growth in Q2-2018, with 9 out of 11 in the double-digit range – a result obviously amplified by fiscal stimulus, but nevertheless better

17 The S&P 500 excluding FAAMG would still be #1



Source: Datastream. *Tech giants = Facebook, Amazon, Apple, Microsoft, Google

than expected (**Chart 18**). We, therefore, stick to our overweight U.S. equity stance.

18 Stellar earnings growth not exclusive to tech sector

	Earnings Summary - S&P 500				Q2/2018 YoY%
	% Reported	% Beat	% Met	% Missed	Blend*
S&P 500	99%	80%	5%	15%	24.9%
Telecom	100%	100%	0%	0%	16.4%
Health Care	100%	92%	2%	6%	18.1%
Technology	99%	92%	3%	6%	26.8%
Staples	97%	90%	6%	3%	13.8%
Industrials	99%	84%	1%	14%	20.3%
Materials	100%	83%	4%	13%	39.9%
Discretionary	100%	82%	5%	13%	23.3%
Utilities	100%	72%	7%	21%	8.7%
Financials	100%	71%	4%	25%	27.2%
Real Estate	100%	59%	22%	19%	3.3%
Energy	100%	45%	6%	48%	123.1%

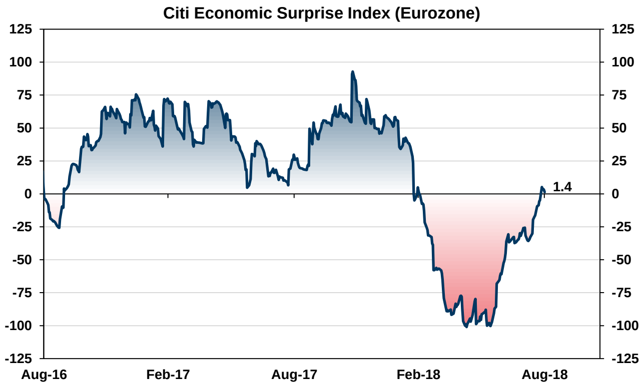
Source: Datastream

As stated in the introduction, the only changes we have made to our geographic mix are to move the S&P/TSX back to neutral and to downsize our EAFE underweight. The combination of Trump relenting on its European car tariffs threat and rebounding Eurozone economic surprise (**Chart 19, next page**) called for some profit taking with regard to our EAFE stance, in our view.

As for Canada, 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 potential deal among Canada, Mexico, and the U.S. will mainly be mirrored in the rates/FX space.

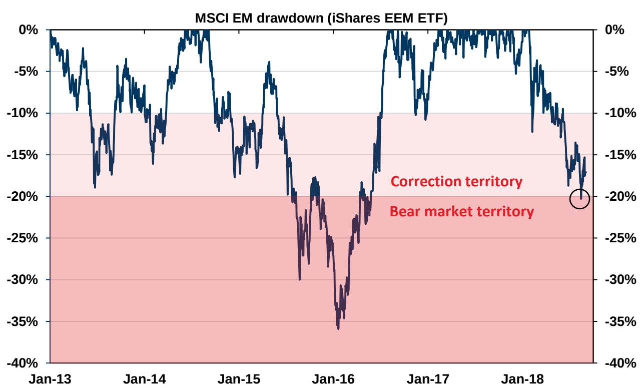
After a 20% downturn in emerging market equities (**Chart 20, next page**), we've also discussed a potential return to a tactical overweight, but concluded that prudence and patience were still appropriate.

19 Economic surprise improving in the Eurozone



Source: Datastream

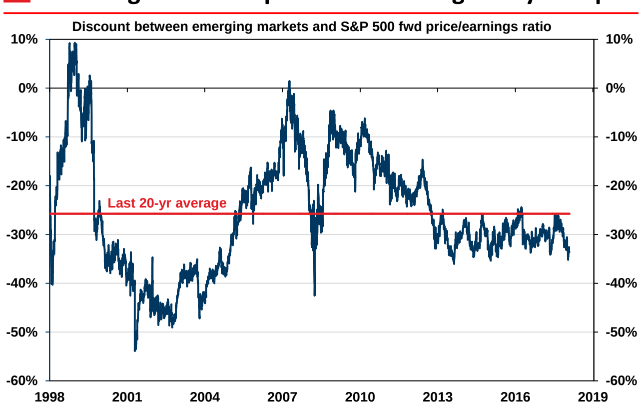
20 Emerging markets have tested bear market territory…



Source: Datastream

For one, EMs are cheap, but perhaps not as much as one might think following such a sell-off. On a 12-month forward price/earnings basis, the MSCI EM index trades at a significant discount (33%) to U.S. equities… but they almost always do (**Chart 21**).

21 … making them cheap… but not outrageously cheap

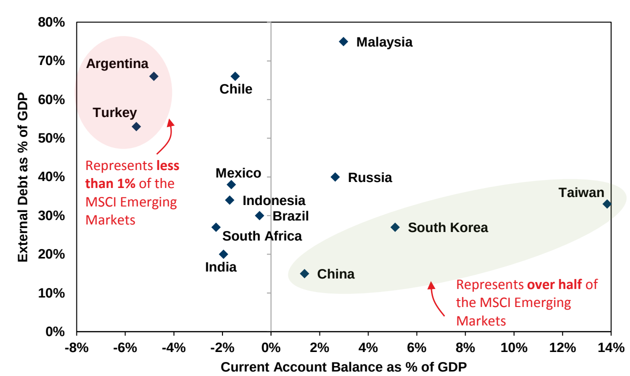


Source: Datastream

For another, there is little reason to expect an easing of tensions between the U.S. and China before November's mid-term election. Trump is walking up to the negotiating table with a thriving national economy, and advised by long-time China critics, such as Peter Navarro (Director of the White House National Trade Council and author of *Death by China: Confronting the Dragon – A Global Call to Action*) and John Bolton (National Security Advisor). 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, the road to get there is likely to be winding.

Finally, country-specific risks out of Turkey and Argentina joined the storm as of late – both countries seeing their currency value cut in half in 2018, arousing typical contagion fears. Challenges faced by these countries should not be trivialized. However, we must emphasize that so-called emerging economies are much less vulnerable to foreign capital flows than back in the 1990s, and that the two countries in question are clear outliers accounting for less than 1% of the MSCI index (**Chart 22**).

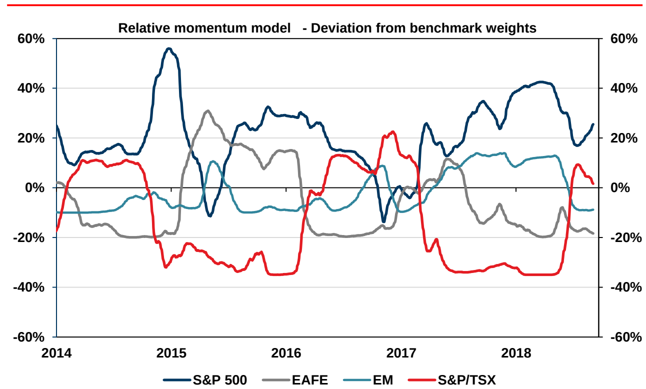
22 Turkey and Argentina are not the norm



Source: Datastream, International Monetary Fund, World Bank

So, what's it going to take for us to move away from our tactical cautiousness on EMs? Clarity on trade and confirmation from our relative momentum model (**Chart 23**).

23 Waiting for a confirmation from our momentum model



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

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