ASSET ALLOCATION STRATEGY

April 2019

NATIONAL BANK INVESTMENTS

Too soon, Mr. Bond?

Highlights

- With Spring before us, most investors will be pleased to find not only their backyard turning green again, but also their portfolios. Whatever the asset class, sector, term, credit, or factor, Q1 has seen substantial gains across the board.
- Nonetheless, it is primarily the yield curve inversion that caught investors' attention in March, a first since August 2007 for this measure with a near-perfect track record of preceding U.S. recessions. Still, before jumping to conclusions and seeking shelter solely on the basis of this observation, we revisit in greater detail what a yield curve inversion truly means and put it into today's context.
- Simply put, the recent flattening of the yield curve tells us that the market believes the Federal Reserve is done hiking rates this cycle, and that growth and inflation risks are skewed to the downside. That being said, we must remember that market beliefs alone do not cause recessions. Recent history shows it can take anywhere between 9 and 31 months before this bond market pessimism materializes into a genuine economic downturn.
- What's more, in each of the last five cycles, U.S. stocks generated positive total returns between the date of the first yield curve inversion and the official start of a recession. It should also be emphasized that monetary policy is within the margin of error of neutrality. This does not completely rule out the risk of an impending recession, but it would certainly be a first in recent history.
- Ultimately, the most reliable recession risk barometer isn't the price of government securities but rather job figures, self-evident though that is. At this point, the U.S. economy is still adding an average of more than 200 k new jobs per month, and we would need to see a material and prolonged deceleration in that number to give more credibility to a recession scenario.
- To be clear, the shape of the yield curve does provide further evidence that the business cycle is aging, but this has been the premise of our asset allocation reports for several months now. Consequently, we remain modestly in favour of risk assets over safer alternatives, and will continue to pay careful attention to key economic indicators in case we might need to quickly revise our expectations of stabilization in global growth.
- March hasn't been particularly revealing in this matter, with some economic figures showing marked declines and others surprising to the upside. However, with the Q1/2019 earnings season just around the corner, we should soon have a better assessment of the situation.
- Despite relatively solid Canadian economic data and surging oil prices, the Loonie remained grounded in March. The Bank of Canada is certainly on the list of suspects, but other factors are likely clouding foreign investors' appetite for the currency. Under these circumstances, it looks increasingly clear that the Loonie could remain stuck in its current narrow trading range for as long as uncertainty keeps the Bank of Canada on the sidelines.
- As for Canadian crude oil, we expect the WCS spread to remain relatively tight as easing cuts make way for additional rail capacity.

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

Market Review

Fixed Income

> Longer-term government bond yields fell markedly last month following an FOMC meeting which sparked growth worries and culminated in the first U.S. yield curve inversion since August 2007.

> Fixed-income assets with longer duration performed especially well in this environment, as the FTSE/TMX Long-term and Overall Universe indices posted strong 4.5% and 2.4% March returns, respectively.

Canadian Equities

> For their part, Canadian equity market returns were less impressive with the S&P/TSX gaining only 1.0%.

> However, this modest figure hides a considerable amount of sector divergence, with the "bond-like" Utilities sector leading the pack along with IT (up 4.6% and 5.6%, respectively) while the Consumer Discretionary and Financial sectors lagged behind (down -1.0 and -1.2%).

> The S&P/TSX Index's Q1 report card remains strong though, as most sectors (9/11) managed to post double-digit returns over the period.

U.S. Equities

> A similar story south of the border, as first quarter double-digit gains held up against last month's weaker performance.

> Financials, a sector particularly sensitive to movements in the spread between short-term and long-term interest rates, was the poorest performer closing out the month -2.6% in the red. On the brighter side, REITS and IT sectors managed to maintain much of their momentum to top out the March leaderboard.

Commodities

> Oil continued its relentless move upwards in March (albeit at a slower pace) on the back of the news that OPEC+ cuts would extend until at least June, gaining another 5.2% to finish with its strongest quarterly performance since Q2/2009.

> A dip at the start of the month saw gold fall below the 1300$ mark. While the lustrous metal seemed set for a remarkable rebound following its early loss, a shift in investor sentiment late in the month saw it dip back down to close out the period at 1292$ per ounce.

Foreign Exchange

> Following a near 2% intra-month swing in value, the U.S. dollar closed on a stronger note, likely supported by higher risk aversion amid fears of further growth deceleration.

> At home, the Loonie depreciated early in the month following the Bank of Canada's especially prudent tone but recouped some of its lost ground on the last day of March, thanks to better than expected January GDP growth figures.

>

Table 2 Market Total Returns

Asset classes	March	Q1	2018
Cash (3-month T-bills)	0.1%	0.4%	1.4%
Bonds (FTSE/TMX Ovr. Univ.)	**2.4%**	**3.9%**	**1.4%**
FTSE/TMX Short term	0.9%	1.7%	1.9%
FTSE/TMX Mid term	2.1%	3.8%	1.9%
FTSE/TMX Long term	4.5%	6.9%	0.3%
FTSE/TMX Government	2.5%	3.9%	1.5%
Federal	1.8%	2.5%	2.4%
Provincial	3.1%	5.2%	0.7%
Municipal	2.9%	4.9%	0.9%
FTSE/TMX Corporate	2.0%	4.0%	1.1%
AA+	1.2%	2.6%	1.8%
A	2.6%	4.7%	0.5%
BBB	2.0%	4.5%	1.0%
BoAML High-Yield (USD)	1.0%	7.4%	-2.3%
Preferred Shares	-0.5%	1.1%	-7.9%
Canadian Equities (S&P/TSX)	**1.0%**	**13.3%**	**-8.9%**
Energy	-0.3%	15.6%	-18.3%
Industrials	3.6%	15.3%	-2.4%
Financials	-1.2%	10.4%	-9.3%
Materials	2.4%	8.5%	-9.3%
Utilities	4.6%	16.1%	-8.9%
Cons. Disc	-1.0%	9.8%	-16.0%
Cons. Staples	3.3%	10.6%	2.0%
Healthcare	2.0%	49.1%	-15.9%
IT	5.6%	26.0%	13.0%
Telecom	2.5%	10.0%	-0.8%
REITs	3.8%	17.5%	2.0%
S&P/TSX Small Cap	-1.1%	10.7%	-18.2%
US Equities (S&P500 USD)	**1.9%**	**13.6%**	**-4.4%**
Energy	2.1%	16.4%	-18.1%
Industrials	-1.1%	17.2%	-13.3%
Financials	-2.6%	8.6%	-13.0%
Materials	1.2%	10.3%	-14.7%
Utilities	2.9%	10.8%	4.1%
Cons. Disc	4.1%	15.7%	0.8%
Cons. Staples	4.1%	12.0%	-8.4%
Healthcare	0.5%	6.6%	6.5%
IT	4.8%	19.9%	-0.3%
Telecom	2.4%	14.0%	-12.5%
REITs	4.9%	17.5%	-2.2%
Russell 2000 (USD)	-2.3%	14.2%	-12.2%
World eq. (MSCI ACWI)	**1.3%**	**12.3%**	**-8.9%**
MSCI EAFE (USD)	0.7%	10.1%	-13.4%
MSCI EM (USD)	0.9%	10.0%	-14.2%
Commodities (CRB index)	**3.1%**	**4.0%**	**-5.4%**
WTI Oil (US$/barrel)	5.2%	33.3%	-25.3%
Gold (US$/ounce)	-1.5%	1.1%	-1.7%
Copper (US$/tonne)	-1.1%	9.0%	-17.5%
Forex (DXY - US Dollar index)	**1.2%**	**1.2%**	**4.4%**
USD per EUR	-1.4%	-1.8%	-4.8%
CAD per USD	1.4%	-2.1%	8.4%

Source: Datastream 2019-03-29

Yield Curve Inversion: Too soon, Mr. Bond?

With Spring before us, most investors will be pleased to find not only their backyard turning green again, but also their portfolios. Whatever the asset class, sector, term, credit, or factor, Q1 has seen substantial gains across the board (**Chart 1**).

1 Back to green just in time for spring

Market Total Returns - Q1/2019

Cross Assets	S&P/TSX Sectors	S&P 500 Sectors	Fixed Income	U.S. Factors	CA Factors
Commo.	Health Care	Materials	HY (US)	Quality	Momentum
15.0%	49.1%	20.0%	7.4%	16.9%	19.4%
US Small	Techno	Techno	Long (Can)	Growth	High Div.
14.6%	26.0%	19.9%	6.9%	16.4%	14.3%
S&P 500	Real Estate	Real Estate	Prov. (Can)	Small	Growth
13.6%	17.5%	17.5%	5.2%	16.0%	13.8%
S&P/TSX	Utilities	Industrials	IG (US)	MSCI USA	S&P/TSX
13.3%	16.1%	17.2%	5.0%	13.9%	13.3%
EAFE	Energy	Energy	Muni. (Can)	Large	Quality
10.1%	15.6%	16.4%	4.9%	13.5%	13.1%
EM	Industrials	Disc.	Corp (Can)	Momentum	Low Vol.
10.0%	15.3%	15.7%	4.0%	12.9%	12.6%
Balanced*	S&P/TSX	Comm. serv.	Overall (Can)	Low Vol.	Large
8.1%	13.3%	14.0%	3.9%	12.5%	12.5%
US HY	Staples	S&P 500	Mid (Can)	Value	Small
7.4%	10.6%	13.6%	3.8%	11.5%	12.4%
Can Bonds	Financials	Staples	Fed. (Can)	High Div.	Value
3.9%	10.4%	12.0%	2.5%	10.6%	11.4%
Can Pref.	Comm. serv.	Utilities	Short (Can)		
1.1%	10.0%	10.8%	1.7%		
C$ per USD	Disc.	Financials	Prefs (Can)		
-2.2%	9.8%	8.6%	1.1%		

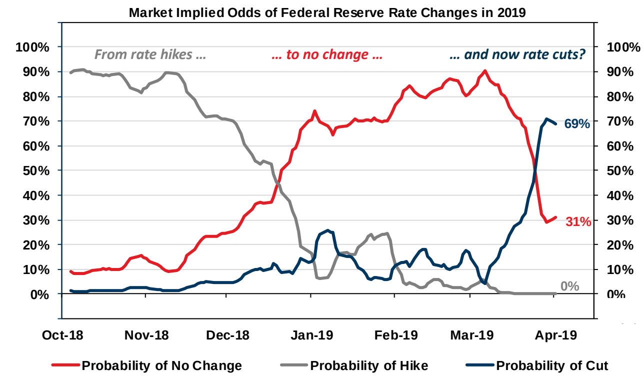
CIO Office (Data via Refinitiv). **Balanced = 40% FTSE TMX Universe, 23% S&P/TSX, 23% S&P 500 (C$), 12% MSCI EAFE (C$), 6% MSCI EM (C$).

Now, this sharp rebound after a turbulent Q4/2018 is not courtesy of Mother Nature, but rather of some easing in trade tensions and, above all, an abrupt U-turn by the Federal Reserve. Just five months ago, markets seemed about as confident as the U.S. Central Bank that 2019 would see further policy tightening, even giving one-in-three chance on a scenario of three rate hikes before the year's end. Nowadays, it is rather the rate-cut option that prevails, based on what is discounted in the Fed Funds Derivative Market (**Chart 2**).

Clearly, the FOMC's March 20th meeting conclusions took markets by surprise after it downgraded its growth forecast, announced an earlier-than-anticipated end to its balance sheet run-off, and signalled no hikes for 2019, down from two (**Chart 3**).

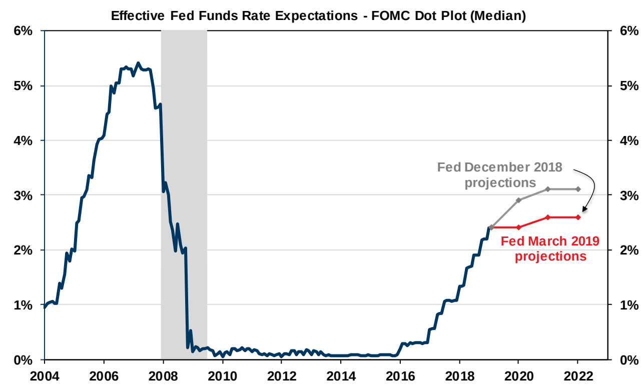
U.S. 10-year Treasury yields reacted particularly strongly to the announcement, while weak economic figures out of Europe shortly afterward provided just enough global growth concerns for the yield curve – measured as the difference between the 3-month and 10-year yields – to turn negative for the first time in this cycle (**Chart 4**).

2 Rapid changes in Fed funds rate expectations...



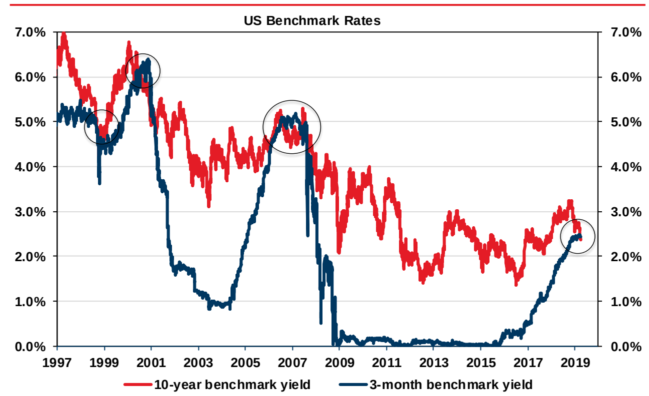
CIO Office (data via Refinitiv)

3 ... after the Fed formalized its *wait-and-see* stance...



CIO Office (data via Refinitiv)

4 ... resulting in the first curve inversion of the cycle



CIO Office (data via Refinitiv)

Why does this matter? Because historically, such inversions have a near-perfect track record of preceding U.S. recessions. Still, before jumping to conclusions and seeking shelter solely on the basis of this measure, let us revisit in greater detail what a yield curve inversion truly means and put it into today's context.

To begin with, it is important to understand what fundamentally drives the spread between yields on short-term and long-term maturities, i.e. the yield curve. Simply put, the yield curve reflects a combination of market expectations for the path of monetary policy rates over the longer-term (a function of real growth and inflation expectations) and a term premium (a function of the uncertainty surrounding real growth and inflation expectations). In other words, the recent flattening of the yield curve tells us that the market believes the Federal Reserve is done hiking rates this cycle and that risks are skewed to the downside.

That being said, we must remember that market beliefs alone do not cause recessions. Case in point, if the last five cycles are any guide, it can take anywhere between 9 and 31 months before this bond market pessimism materializes into a genuine economic downturn (**Chart 5**, **Panel 1**).

What's more, in each of the last five cycles, U.S. stocks generated positive total returns between the date of the first yield curve inversion and the official start of a recession. Again, this supports the argument that there is no reason to rush for the exit strictly on this basis (**Chart 5, Panel 2**).

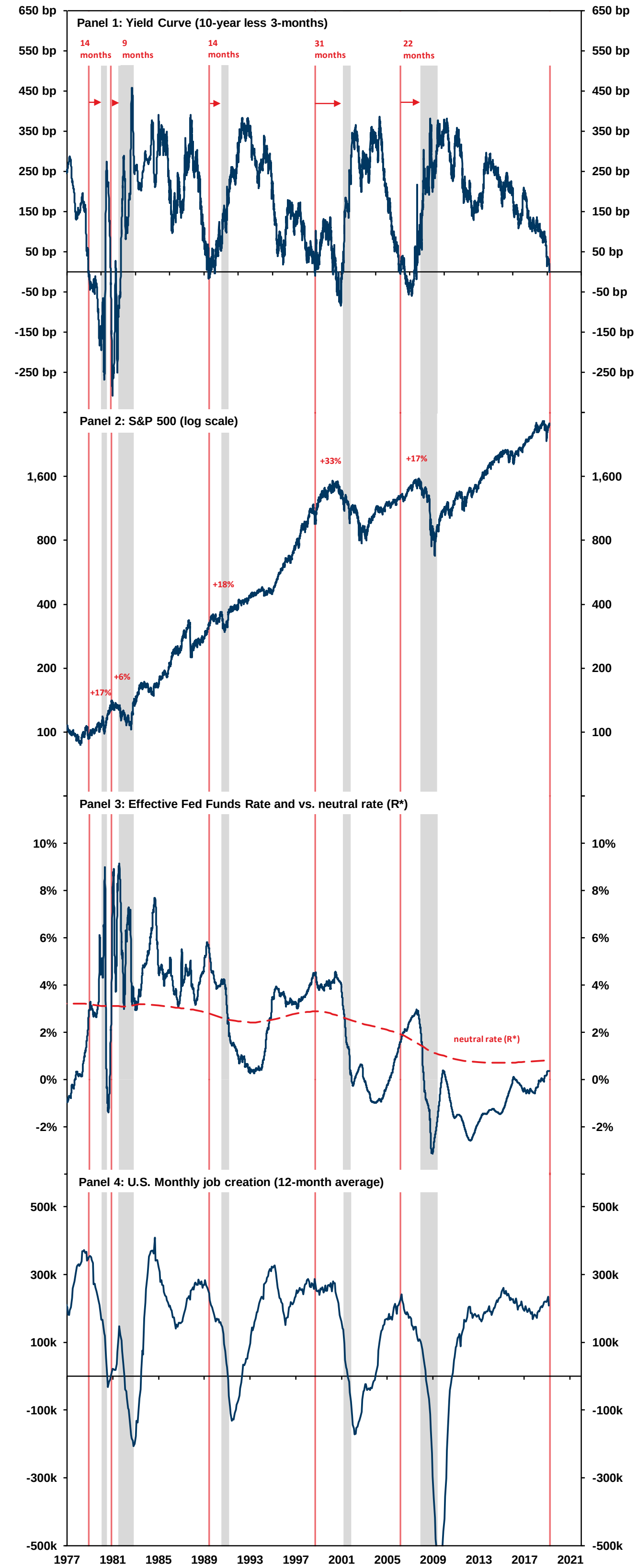
It should also be emphasized that significantly restrictive monetary policy by the Federal Reserve, a factor common in each of the last five recessions, has yet to be observed. For instance, if we compare the real policy rate against the Fed's own estimate of the neutral rate (i.e. neither accommodative nor restrictive), we can only note that, at worst, monetary policy is within the margin of error of neutrality. This does not completely rule out the risk of an impending recession, but it would certainly be a first in recent history (**Chart 5, Panel 3**).

Ultimately, the most reliable indicator of an economy heading into a recession isn't the price of various government securities, but rather job figures, self-evident though that is. At this point, the U.S. economy is still adding an average of more than 200 k new jobs per month, and we would need to see a material and prolonged deceleration in that number to give more credibility to a recession scenario (**Chart 5, Panel 4**).

Before concluding, one last remark is in order. As mentioned earlier, the yield curve is partly influenced by the term premium, i.e. the extra compensation investors demand to hold longer-term assets subject to growth and inflation surprises. Quite interestingly, the Fed's own estimate of this component has been negative for most of the last four years, meaning that 10-year Treasury investors are willing to pay for bearing these risks (**Chart 6, next page**).

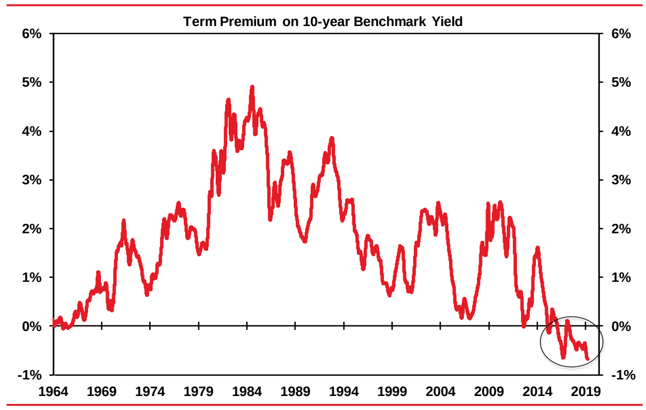
Reasons for such a counter-intuitive finding are open for debate. But, according to the Federal Reserve itself, it could be a result of central banks asset purchases and, consequently, would

5 A glance at past yield curve inversions



CIO Office (data via Refinitiv). Neutral rate estimates from Laubach and Williams (2003). Real rate measured using core PCE inflation (12-month moving average).

6 Paying to bear risks: a non negligeable anomaly



CIO Office (data via Refinitiv, Adrian, Crump, and Moench (2013) estimates)

undermine the reliability of the yield curve as a recession forecasting tool:

> "On the one hand, an inverted yield curve could indicate an increased risk of recession; on the other hand, the low level of term premiums in recent years — reflecting, in part, central bank asset purchases — could temper the reliability of the slope of the yield curve as an indicator of future economic activity."
>
> *Minutes of the FOMC meeting from September 25-26, 2018.*

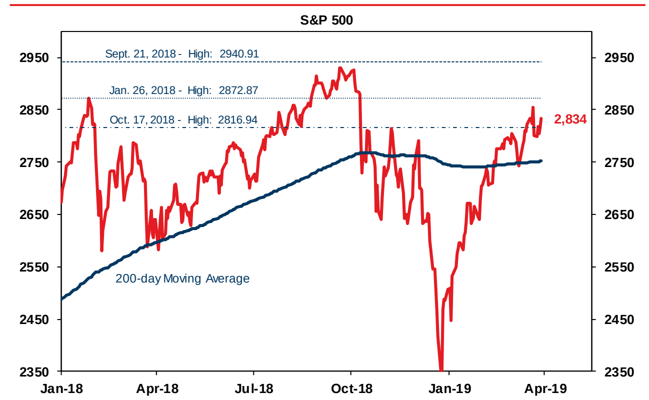
So, what are the key takeaways from all this technical jargon? For now, it would be misguided to expect an imminent recession and to avoid risk assets solely on the basis of the recent yield curve inversion. Knowing that history has shown us this measure does not pose an immediate threat to markets, we would need to see a clear deterioration in labour market indicators to really grow concerned about the economic backdrop. This is especially apt considering that U.S. monetary policy is not yet restrictive, and that there are valid reasons to believe the yield curve is somewhat distorted by central banks' balance sheet management worldwide.

To be clear, the shape of the yield curve does provide further evidence that the business cycle is aging, but this has been the premise of our asset allocation reports for several months now. Consequently, we remain modestly in favour of risk assets over safer alternatives, and will continue to pay careful attention to key economic indicators in case we might need to quickly revise our expectations of stabilization in global growth.

Equities: Earnings Ahead

While equity investors initially welcomed the Federal Reserve's March 20th dovish statement with optimism, the contrasting read from their bond market peers which culminated in the yield curve inversion somewhat cooled their enthusiasm. The S&P 500 nevertheless ended March on a positive note, but the path upwards remains strewn with technical thresholds to overcome (**Chart 7**).

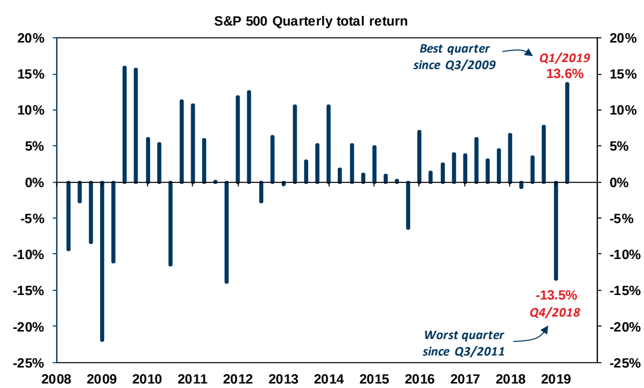
7 The rise continues, but resistance remains



CIO Office (data via Refinitiv)

In this context, it is understandable for investors to question how much upside is left, especially in view of year-to-date returns, which, for most equity indices, are already in the double digits. However, rather than focusing on the calendar-year returns, which for 2019 happens to start near a 20% market correction trough, we suggest taking a step back from the wild gyrations of the last two quarters that cancel each other out (**Chart 8**).

8 From worst quarter since 2011 to best since 2009

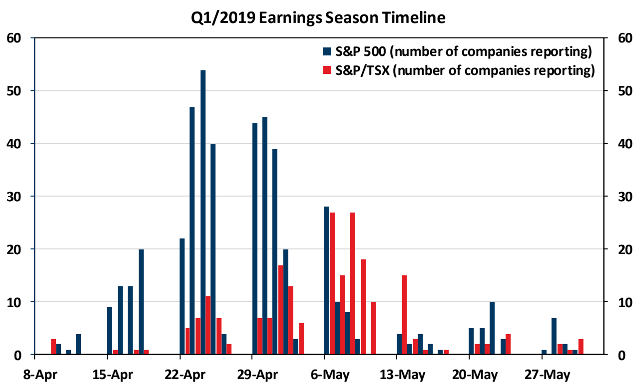


CIO Office (data via Refinitiv)

For instance, on a year-over-year basis, the S&P 500 is up 7.3% (9.5% total return), a performance in line with historical averages, and with our previous expectations of single-digit returns and high volatility which still apply today.

As we argued in our last report, with nearly all central banks on hold and Sino-American trade negotiations ostensibly moving in a positive direction, the key factor to drive equity movements over the next few months should be the state of global growth. March hasn't been particularly revealing in this matter, with some figures showing marked declines (European Flash PMIs, U.S. Nonfarm Payrolls, Canadian Q4/2018 GDP growth) and others surprising to the upside (Chinese PMIs, German IFO Business Climate, Canadian employment and January 2019 GDP figures). However, with Q1/2019 earnings season just around the corner, we should soon get a better assessment of the situation (**Chart 9**).

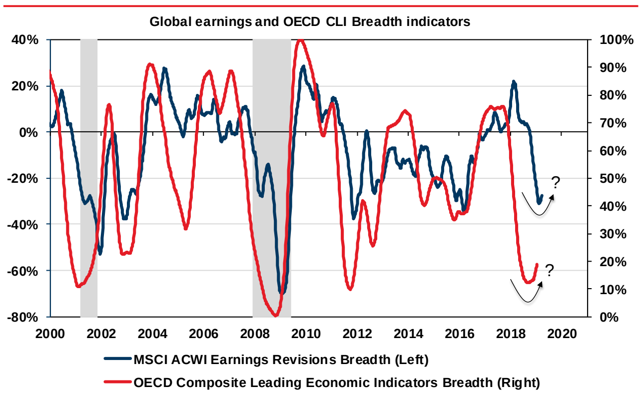
9 Earnings season ahead



CIO Office (data via Refinitiv)

On the bright side, we've noted a reversal in the breadth of both Global Equity earnings revisions and OECD Composite leading economic indicators, which suggests that we might now be past the low point in the recent global growth slowdown (**Chart 10**).

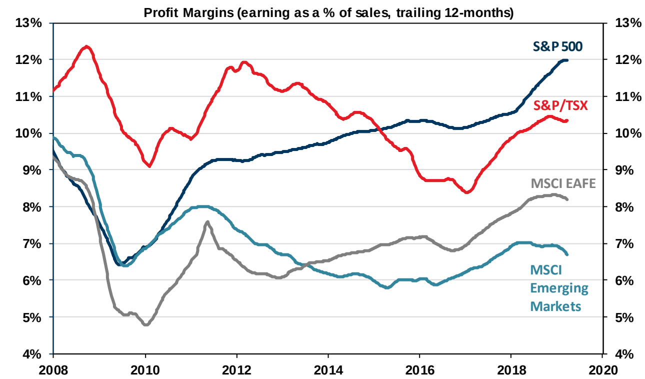
10 Bottoming process in the making?



CIO Office (data via Refinitiv)

On a gloomier note, profit margins seem set to decline in the face of rising input prices, in particular wages and raw material costs. This holds especially true in the U.S. where equities have benefitted from an almost uninterrupted rise in margins over the last decade (**Chart 11**). Market expectations are already pointing to a -1.7% negative impact from margins on S&P 500 2019 earnings growth, but it remains to be seen whether this represents a fair estimate.

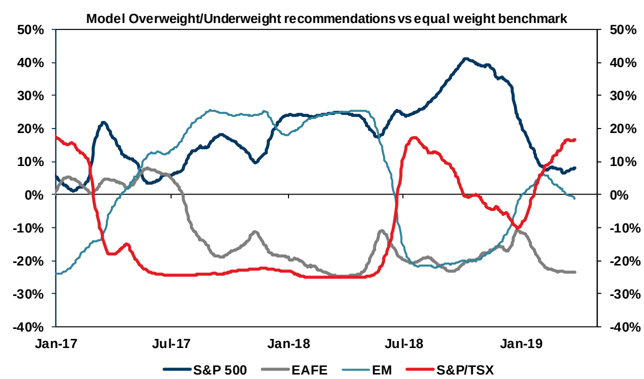
11 Record U.S. profit margins are likely to ease back



CIO Office (data via Refinitiv)

Shifting our focus to geographical leadership, our asset allocation remains unchanged from last month (a slight overweight in Canadian and emerging markets, underweight EAFE, and neutral U.S. stance). We stand ready to adjust our deviations should clearer trends emerge, but do not yet see the need for any such move based on our relative momentum model recommendations (**Chart 12**).

12 No clear sign of change in geographical leadership



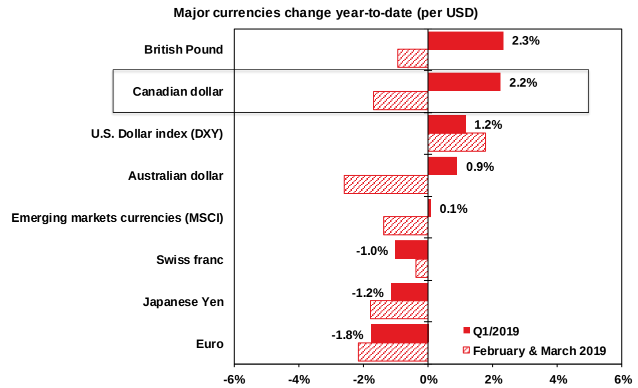
CIO Office (data via Refinitiv)

Currencies: Suspects Wanted

In contrast to its bond cousin, it is with relative calmness that the currency market wrapped up the first quarter of 2019, with the exception, of course, of the British pound subject to the daily twists and turns of Brexit. For the Canadian dollar, this entails a modest 1.4% increase so far in 2019, a rise fully realized at the start of the year, whereas the last two months actually saw the Loonie lose some feathers (**Chart 13, next page**).

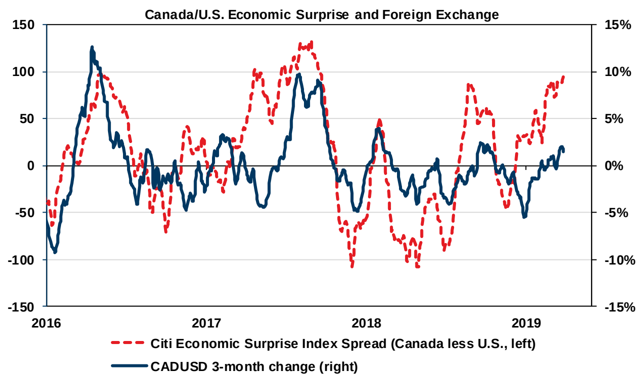
Canadian economic figures can hardly be blamed for the currency weakness of February and March. Quite the contrary, as evidenced by the surge in the Citi Economic Surprise index our side of the border (**Chart 14, next page**). The same applies for Canadian energy prices, with WCS crude oil steadily

13 Difficult for the Loonie to gain altitude...



CIO Office (data via Refinitiv)

14 ... but one cannot blame the Canadian economy



CIO Office (data via Refinitiv)

increasing through the quarter and finishing up a whopping 71%.

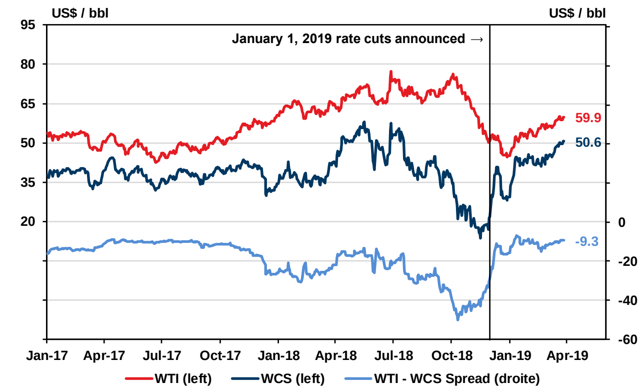
For its part, the Bank of Canada's especially bleak assessment of the global economy on March 6 – which raised uncertainty over the path back to the neutral rate – is certainly on the list of suspects. Nevertheless, on a relative basis, this change of tone isn't much different from that of the Federal Reserve, which leaves room for other suspects.

Could it be foreign investors' lack of appetite for cyclical currencies such as our own in this time of global recessionary fears? Or perhaps because of concerns over Canada's household debt burden and housing market slowdown that recurs every so often? What about uncertainty over the ratification of the USCMA Trade Agreement still in the works? Each of these suspects must have some impact, but it remains hard to quantify. What seems increasingly likely though is that the Loonie could remain stuck in its current narrow trading range as long as uncertainty keeps the Bank of Canada on the sidelines.

Commodities: Come Rail or High Water

In what was a tremendous start to the year for American light crude, the commodity bounced back from its deep December depths to post its best quarterly performance (33%) since Q2/2009. North of the border, Alberta Premier Rachel Notley's January 1 production cuts undoubtedly had their intended effect as the WCS-WTI spread quickly contracted, with the Canadian benchmark closing March just 9.3$ below its U.S. counterpart (**Chart 15**).

15 Back to normal for Canadian crude oil



CIO Office (data via Refinitiv)

Moving forward, we expect the spread to remain relatively tight, as easing cuts make way for additional rail capacity. While supply management alone can't solve the country's more structural oil transportation-related woes (we have in mind here the legal and political hurdles facing, among others, Enbridge's Line 3 Replacement and TransCanada's Keystone XL projects), these issues should not materially impact prices in the short term.

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General

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