NATIONAL BANK INVESTMENTS

ASSET ALLOCATION STRATEGY

August 2019

Start With Why

Highlights

- It is in relative calm that global markets progressed in the first third of the summer quarter, with world equities outpacing fixed-income assets by a hair, and U.S. stocks outmaneuvering their peers for a second consecutive month.
- Central banks once again dominated the financial media space in recent weeks, with the Bank of Canada reiterating the need for an accommodative monetary policy in light of trade tensions, the European Central Bank setting the stage for a September rate cut and, last but not least, the Federal Reserve cutting its policy rate for the first time since the aftermath of the financial crisis.
- Under these circumstances, and exceptionally for this mid-summer edition, we decided to break from the usual format of our monthly report by doing our very own adaptation of the *why* and *how* of central banking in a nod to Simon Sinek's famous *Start With Why*. While what follows may risk sounding redundant to seasoned investors, we strongly believe that a dose of historical perspective summarized neatly in a concise and simplified manner can never be a waste of time, especially given the importance of the subject matter at hand.
- Why do we have central banks? We argue that, in its most basic form, the main purpose of having an independent institution in charge of monetary policy is to smooth out the inevitable ups and downs of business cycles so that a society and its people can achieve their full growth potential without the adverse effects of wild economic fluctuations. Looking at U.S. data going back 164 years, we do observe a significant and gradual reduction in the vagaries of the economy after the creation of the Federal Open Market Committee (FOMC) in 1935.
- How do central banks manage to achieve their 'why?' While there are some nuances from country to country, the 'how' of all modern-day major central banks evolves around ensuring stability in prices (inflation) through the use of monetary policy.
- It is important to emphasize that economists' understanding of interactions amongst growth, inflation, and monetary policy have significantly evolved through the years and continue to do so today. But, ultimately, a central bank's most valuable asset is public trust. As such, President Trump's relentless attacks toward the Federal Reserve as well as the risk of perceived political interference may well pose greater threats in the long-run to the Fed's ability to fulfill its mandate than an insufficient or misused monetary policy toolbox ever could.
- What does the Federal Reserve's decision to cut its policy rate on July 31 – despite a still very robust U.S. economy – tell us? Its reaction function now gives more weight to global uncertainties and economies outside of its jurisdiction than in the past.
- We reiterate our view that the U.S. Central Bank's renewed preference for an accommodative monetary policy should materialize in one more rate cut by the end of the year, a positive for the life expectancy of both the current economic cycle and the equity bull market. We are nonetheless maintaining our tactical allocation between stocks and bonds at benchmark weight in view of the potential for higher volatility in the near-term. Geographically, we also continue to favour North American equities against those of Europe, Australasia, and the Far East (EAFE).

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			■		

CIO Office

Current Allocation ■

Previous Allocation

Market Review

Fixed Income

> U.S. 10-year Treasury yields dipped below 2% early in July on the back of an expectation for substantial monetary easing. But, tailwinds in the form of overall positive economic data in the U.S. helped push rates back above this key psychological level and keep them there for the remainder of the period.

> Overall, Bond indices were flat as rates across all tenors finished relatively unmoved from a month ago.

Canadian Equities

> Finishing near where it started, the S&P/TSX's performance was dragged down last month in part by cannabis-infused weakness in the Healthcare sector and an underperforming Energy sector falling prey to the vagaries of oil prices.

> Top performers for July were the IT (up 3.2%) and Consumer Discretionary sectors (up 3.5%).

U.S. Equities

> The S&P 500 appreciated the most of any major asset class last month, on the heels of a positive earnings season that is now just past its midpoint.

> Results across sectors were still mixed though, as four of them failed to deliver gains in July. The biggest drags were Energy and Healthcare, the former dropping as uncertainty around the direction of oil prices rose, and the latter facing headwinds from an increasingly hostile legislative body.

> Meanwhile, the IT sector continued its marked outperformance, sharing the top spot this month with Communication Services, both seemingly unfazed by the Justice Department's recent call for an antitrust review of Big Tech.

Commodities

> Following its impressive climb in June, gold spent the last month treading water instead, as a strengthening U.S. dollar worked to undo the positive price effects that inflation data coming in a touch above expectations as well as a rate cut from the Fed might have had on the lustrous metal.[1]

> WTI crude oil prices finished a volatile month marginally higher at 58.6$/bbl against a backdrop of concerns about the health of the global economy and escalating tensions between Washington and Teheran.

Foreign Exchange

> The U.S. Dollar Index rose in July as a balance of positive economic news at home stood in contrast to deteriorating indicators abroad—especially so in the Eurozone where the ECB seemed to open the possibility of a return to large-scale QE in the months to come.

> A somewhat directionless period, July saw the Loonie remain within a narrow trading band.

Table 2 Market Total Returns

Asset Classes	July	YTD	12 months
Cash (3-month T-bills)	0.1%	1.0%	1.6%
Bonds (FTSE/TMX Ovr. Univ.)	**0.2%**	**6.7%**	**8.3%**
FTSE/TMX Short term	0.0%	2.7%	4.2%
FTSE/TMX Mid term	0.1%	6.1%	8.5%
FTSE/TMX Long term	0.4%	12.6%	13.8%
FTSE/TMX Government	0.1%	6.5%	8.4%
Federal	-0.1%	3.9%	6.4%
Provincial	0.2%	9.0%	10.3%
Municipal	0.3%	8.5%	9.8%
FTSE/TMX Corporate	0.4%	7.3%	8.2%
AA+	0.1%	4.2%	5.8%
A	0.5%	8.8%	9.6%
BBB	0.6%	8.1%	8.7%
BoAML High-Yield (USD)	0.5%	10.7%	6.9%
Preferred Shares	1.3%	0.4%	-9.3%
Canadian Equities (S&P/TSX)	**0.3%**	**16.6%**	**3.0%**
Energy	-3.9%	8.0%	-16.7%
Industrials	1.8%	23.3%	7.7%
Financials	1.1%	15.5%	3.6%
Materials	2.3%	17.1%	7.1%
Utilities	1.8%	24.6%	20.0%
Cons. Disc	3.5%	19.0%	-3.3%
Cons. Staples	1.6%	14.2%	18.6%
Healthcare	-13.3%	17.3%	9.4%
IT	3.2%	48.6%	40.3%
Comm. Svc.	-1.1%	8.6%	9.2%
REITs	2.1%	18.3%	12.5%
S&P/TSX Small Cap	3.1%	13.9%	-4.3%
US Equities (S&P500 USD)	**1.4%**	**20.2%**	**8.0%**
Energy	-1.8%	11.1%	-16.0%
Industrials	0.7%	22.2%	3.6%
Financials	2.4%	20.1%	3.5%
Materials	-0.4%	16.8%	-0.1%
Utilities	-0.3%	14.4%	16.5%
Cons. Disc	1.0%	23.0%	9.2%
Cons. Staples	2.5%	19.1%	14.6%
Healthcare	-1.6%	6.3%	4.3%
IT	3.3%	31.4%	15.7%
Comm. Svc.	3.4%	23.1%	14.8%
REITs	1.7%	22.5%	17.6%
Russell 2000 (USD)	0.5%	16.8%	-5.8%
World Eq. (MSCI ACWI)	**0.3%**	**17.0%**	**3.5%**
MSCI EAFE (USD)	-1.3%	13.1%	-2.1%
MSCI EM (USD)	-1.1%	9.5%	-1.8%
Commodities (CRB index)	**-1.2%**	**-1.5%**	**-6.7%**
WTI Oil (US$/barrel)	0.6%	29.6%	-16.2%
Gold (US$/ounce)	1.1%	11.4%	16.8%
Copper (US$/tonne)	-1.3%	-0.8%	-6.0%
Forex (DXY - US Dollar index)	**2.5%**	**2.4%**	**4.3%**
USD per EUR	-2.2%	-2.6%	-4.8%
CAD per USD	0.8%	-3.3%	1.4%

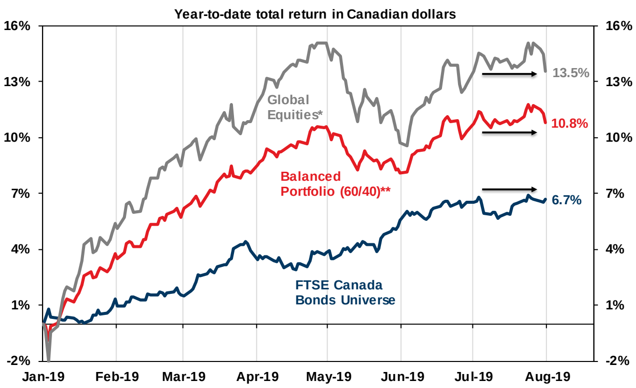
CIO Office (data via Refinitiv) 2019-07-31

[1] Please see last month's AAS "Easy Does It" (July 2019) for a deeper dive into the interplay between these three forces and the price of gold.

Start With…

It is in relative calm that global markets progressed in the first third of the summer quarter, with world equities (MSCI ACWI +0.3% in July) outpacing fixed-income assets (FTSE Canada Bonds +0.2%) by a hair, and U.S. stocks (S&P 500 +1.4%) outmaneuvering their peers (S&P/TSX +0.3%, MSCI EM -1.1%, MSCI EAFE -1.3%) for a second consecutive month. As a result, our index of a plain vanilla 60/40 portfolio is now up by 10.8% year-to-date (**Chart 1**).

1 Global markets progressed horizontally in July…



CIO Office (data via Refinitiv). *(35% S&P/TSX, 35% S&P 500 C$, 20% MSCI EAFE C$, 10% MSCI EM C$)
**(60% Global equities*, 40% FTSE TMX Canada Bonds Universe)

Despite such low volatility, July was a busy month in terms of news starting with Boris Johnson's arrival at 10 Downing Street and pledging to leave the European Union on October 31 "no ifs, no buts." We've also witnessed a resumption of face-to-face negotiations between Washington and Beijing, a positive development in a conflict that nevertheless continues to weigh on growth prospects, as highlighted by the IMF's updated World Economic Outlook that now sees world GDP growth at 3.2% in 2019, the weakest pace in 10 years.

On the economic data front, the U.S. unequivocally surprised positively, with better-than-expected job creation (+224k in June), retail sales (+0.4%), durable goods orders (+1.2%, ex-transport), Q2 GDP growth (+2.1%), and earnings results (74% beat ratio, **Chart 2**).

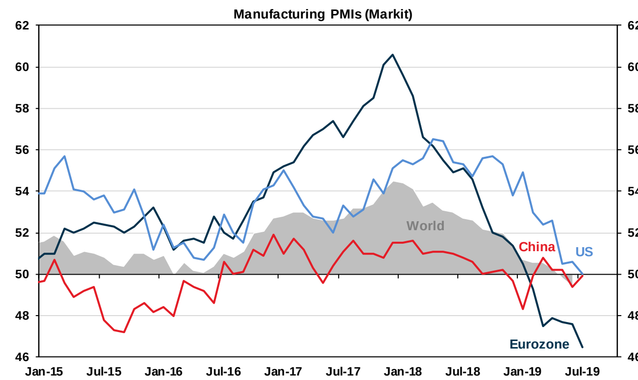
2 … with corporate America positively surprising…

	Earnings Summary - S&P 500				Q2/2019 YoY%
	% Reported	% Beat	% Met	% Missed	Blend*
S&P 500	65%	74%	9%	17%	2.2%
Financials	87%	71%	5%	24%	9.7%
Industrials	82%	75%	9%	16%	-9.1%
Real Estate	72%	74%	17%	9%	3.4%
Health Care	66%	93%	2%	5%	8.7%
Energy	62%	78%	6%	17%	-13.2%
Materials	59%	81%	0%	19%	-15.9%
Staples	55%	72%	11%	17%	0.9%
Technology	55%	69%	14%	17%	-2.8%
Discretionary	54%	65%	18%	18%	-0.3%
Comm. Sev.	48%	77%	8%	15%	18.5%
Utilities	39%	45%	0%	55%	-2.3%

CIO Office (data via Thomson Reuters Eikon, as of July 31st).

However, not everything was rosy worldwide, as global manufacturing activity continued to send out warning signals, especially in the Eurozone where the Markit Flash Manufacturing PMI reading for July fell significantly (**Chart 3**).

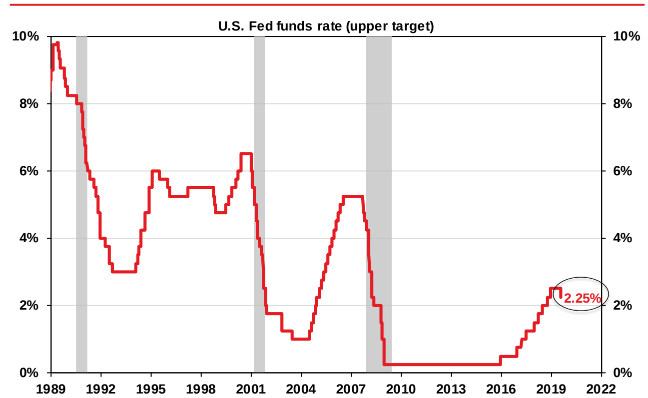
3 … and global manufacturing activity further declining



CIO Office (data via Refinitiv).

That said, it is once again central banks that dominated the financial media space which explains most of the market action in recent weeks—with the Bank of Canada reiterating the need for an accommodative monetary policy in light of trade tensions, the European Central Bank setting the stage for a September rate cut and, last but not least, the Federal Reserve cutting its policy rate for the first time since the aftermath of the financial crisis (**Chart 4**).

4 First rate cut in a decade for the Federal Reserve



CIO Office (data via Refinitiv).

In our last *Asset Allocation Strategy* report, we briefly revisited the core of the U.S. Central Bank's jobs so as to better understand what could justify a rate cut, concluding that the Federal Reserve had leeway to buy insurance against the risk that global uncertainties—especially with regard to the U.S./China tariff spat—end up materially affecting the economy. But, as we all well know, there is no such thing as free insurance. In this case, greater confusion about the actual role of monetary policy and rising doubts surrounding the Fed's independence seem to be part of the price to be paid.

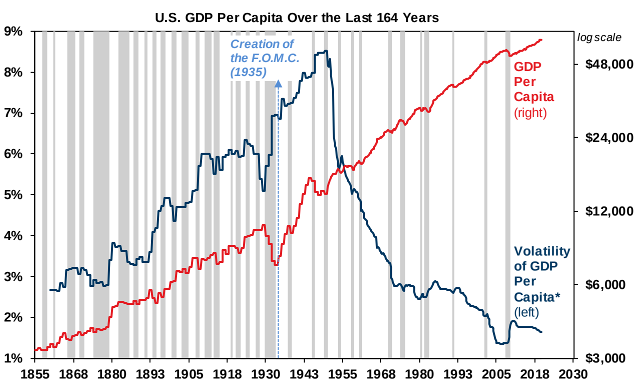
Under these circumstances, and exceptionally for this mid-summer edition, we decided to break from the usual format of our monthly report by doing our very own adaptation of the '*why*' and '*how*' of central banking in a nod to Simon Sinek's famous *Start With Why*. While what follows may risk sounding redundant to seasoned investors, we strongly believe that a dose of historical perspective summarized neatly in a concise and simplified manner can never be a waste of time, especially given the importance of the subject matter at hand.

… Why?

Why do we have central banks? Asking such a broad question to ten economists is sure to elicit at least twenty different answers. However, we argue that, in its most basic form, the main purpose of having an independent institution in charge of monetary policy is to smooth out the inevitable ups and downs of business cycles so that a society and its people can achieve their full growth potential without the adverse effects of wild economic fluctuations.

Looking at U.S. data going back 164 years, we do observe a significant and gradual reduction in the vagaries of the economy after the creation of the Federal Open Market Committee (FOMC) in 1935. During the previous 80 years, U.S. citizens spent nearly half (44%) their time in recessions. In contrast, only 13% of the following 84 years saw the economy fall back into recessionary periods, each of which lasted only half as long, on average, as before (7 quarters pre-FOMC versus 3.6 quarters post-FOMC) (**Chart 5**).

5 A more predictable and less volatile economy…

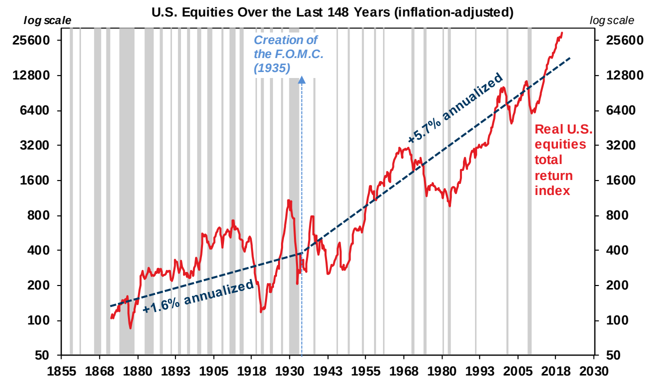


CIO Office (data via Refinitiv, FRED, Maddison Project). GDP Per Capita is in constant 2011 US$. Data prior to 1950 is from the *Maddison Project Database*. *Volatility of GDP per capita represents the standard deviation of YoY change in GDP per capita over a rolling 20-year period.

Living in a more predictable and less volatile economic environment understandably made life easier for businesses (and households!) looking to invest in value-added projects spanning multiple years, or even decades. Consequently, U.S. equities went from growing at a poor 1.6% real annualized rate before 1935 to 5.7% thereafter, a much better representation of their long-run potential (**Chart 6**).

Of course, such a track record doesn't shield the Federal Reserve from critics, with none other than the U.S. President leading the charge recently, going so far as to tweet on July 5 that "our most difficult problem is not our competitors, it is the

6 … makes all the difference for equity markets



CIO Office (data via Robert Shiller, FRED).

Federal Reserve." To be fair, Trump was not completely mistaken when he later added that "If we had a Fed that would lower interest rates, we would be like a rocket ship." The problems are that rockets are not known for their smooth landings, and an economy that is running too fast is likely to crash at the slightest turn—precisely what the Fed wants to avoid.

On the other side of the spectrum, we also find a number of critics arguing that the last decade of near-zero policy rates and asset-purchase programs further deepened wealth inequality by inflating the price of stocks and bonds mostly held by high earners. At first glance, this argument may seem accurate. Yet, we may question what would have happened to everyone's income, employment, and pension funds (public and private) had central banks decided to play it more conservatively, effectively letting the 2008/2009 recession last longer, risking a deflationary spiral *à la* 1930s, and threatening the ability of governments to fund their social programs. Taking all these factors into consideration, the existing literature and current evidence suggest that the actions taken by central banks had little to no negative influence on inequality.[2] That is not to say that income inequality isn't problematic. In fact, according to Fed. Chairman Jerome Powell himself, the widening wealth gap is the biggest challenge facing the U.S. over the next decade, together with sluggish productivity.[3] These issues, however, require thinking that goes beyond the mandate of a central bank.

How?

How do central banks manage to achieve their '*why*,' i.e. mitigate large economic fluctuations for the greater good? While there are some nuances from country to country, the '*how*' of all modern-day major central banks evolves around ensuring stability in prices (inflation) through the use of monetary policy.

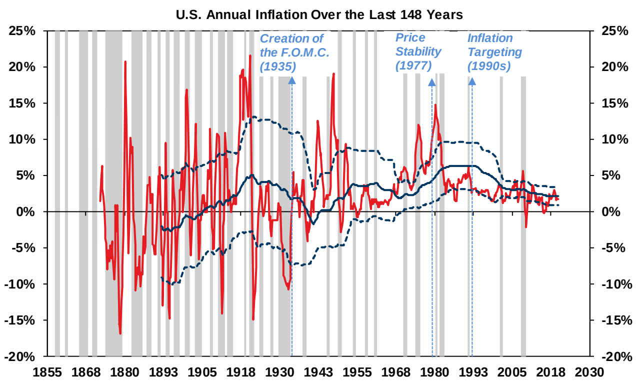
History has indeed shown the clear benefits of avoiding unpredictable fluctuations in the purchasing power of money as a means of promoting efficiency and long-term growth. A

[2] Pedro Amaral. "Monetary Policy and Inequality." Federal Reserve Bank of Cleveland Economic Commentary, January 2017.

[3] Federal Reserve Teacher Town Hall. Washington D.C., February 6, 2019.

look at U.S. inflation data going back to 1871 attests to the substantial progress achieved in that direction (**Chart 7**).

7 Price stability is the cornerstone for central banks



CIO Office (data via Robert Shiller and FRED). Blue lines = 20-year moving average +/- 1 standard deviation.

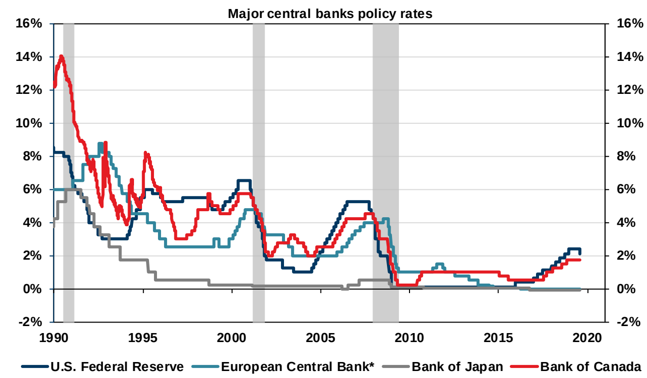
It is important to emphasize that economists' understanding of interactions amongst growth, inflation, and monetary policy have significantly evolved through the years and continue to do so today. For instance, it was not until the 1970s experience with stagflation that aiming for low and stable inflation gained popularity among central bankers. In addition, inflation-targeting, as we know it, only dates back to the early 1990s with Canada among the first countries to adopt this approach in 1991, while the U.S. Federal Reserve only resolved to formalize its 2% inflation target in 2012.

Nowadays, central banks' main tool in conducting monetary policy remains that of setting short-term (overnight) interest rates either above (to prevent inflation/growth from overheating) or below (to stimulate inflation/growth) their estimate of the neutral rate (level consistent with an economy at full employment and on-target inflation). However, with the last recession pushing policy rates to near zero, another tool gained prominence with the aim of extending central bank's influence over longer-term interest rates (among other things): large-scale asset-purchasing programs, or quantitative easing (**Chart 8 and 9**).

The persistence of such "unconventional" measures ten years after the last recession certainly fuel concerns about the ability of monetary authorities to act promptly in the event of a serious economic downturn. And so, it is especially in times like these that central bank credibility is most important. As former Governor of the Bank of England, Mervyn King, stated: "the real influence of monetary policy is less the effect of any individual [policy rate change] and more the ability of the framework of policy to condition inflation expectations."[4] Put more simply, it isn't so much the policy rate which matters, but whether people believe the central bank is capable of achieving its mandate.

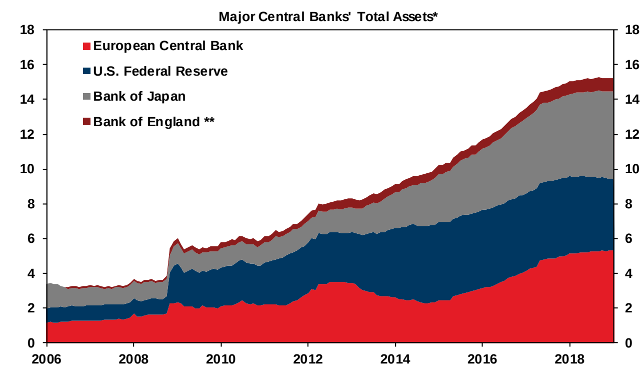
As such, it is no coincidence that many central banks have kept on gradually increasing the frequency and quality of communications, a recent example being the Federal Reserve's introduction of press conferences at every meeting this year.

8 Near zero policy rates following the last recession…



CIO Office (data via Refinitiv). *Germany's Bundesbank discount rate before 1999.

9 … gave rise to large asset-purchasing programs



CIO Office (data via Refinitiv). *In Trillions of USD, fixed conversion date as at 2018-12-31.
**BoE methodological break after Sept. 2013

That way, they not only avoid unnecessarily surprising markets, but also make sure to reiterate their capacity and willingness to achieve their statutory mandate should doubts begin to spread.

Ultimately, as King alluded and in Powell's own words,[5] a central bank's most valuable asset is public trust. As such, President Trump's relentless attacks toward the Federal Reserve as well as the risk of perceived political interference may well pose greater threats in the long-run to the Fed's ability to fulfill its mandate than an insufficient or misused monetary policy toolbox ever could.

So What?

The key point to remember from the above is that any policy action taken by an independent central bank is the result of an ever-evolving assessment of the best route to promote sustained growth and avoid large economic fluctuations.

The Federal Reserve's decision to cut its policy rate on July 31—despite a still very robust U.S. economy—confirms that its reaction function now gives more weight to (1) global uncertainties and (2) economies outside of its jurisdiction. This

[4] Mervyn King. "Monetary policy: Practice ahead of theory." Mais Lecture, 2005

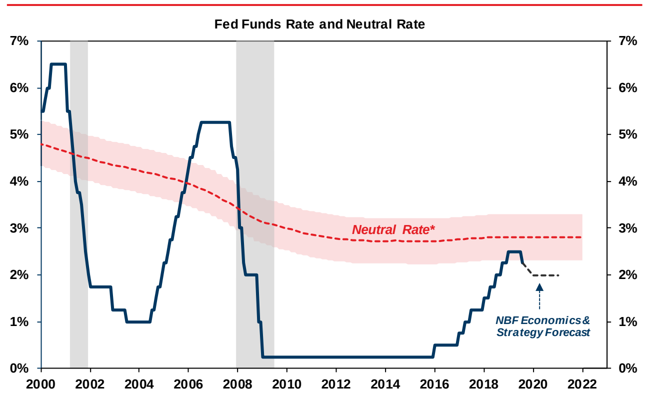
[5] Chair Jerome H. Powell. "Monetary Policy: Normalization and the Road Ahead." SIEPR Economic Summit, Stanford Institute of Economic Policy Research, March 2019.

change from a traditionally more domestic-data dependent approach was indeed apparent from Powell's speech about monetary policy in the post-crisis era delivered in Paris last month:

> *Since the crisis, policymakers are even more keenly aware of the relevance of global factors to our policies. The global nature of the financial crisis and the channels through which it spread sharply highlight the interconnectedness of our economic, financial, and policy environments. U.S. economic developments affect the rest of the world, and the reverse is also true.*
>
> *In addition, we have seen how monetary policy in one country can influence economic and financial conditions in others through financial markets, trade, and confidence channels. Pursuing our domestic mandates in this new world requires that we understand the anticipated effects of these interconnections and incorporate them into our policy decision-making.*
>
> \- *Jerome Powell, July 16, 2019*

Consequently, we reiterate our view that the Federal Reserve's renewed preference for an accommodative monetary policy should materialize in one more rate cut by the end of the year, a positive for the life expectancy of both the current economic cycle and the equity bull market (**Chart 10**).

10 Back to an accommodative monetary policy for the Fed

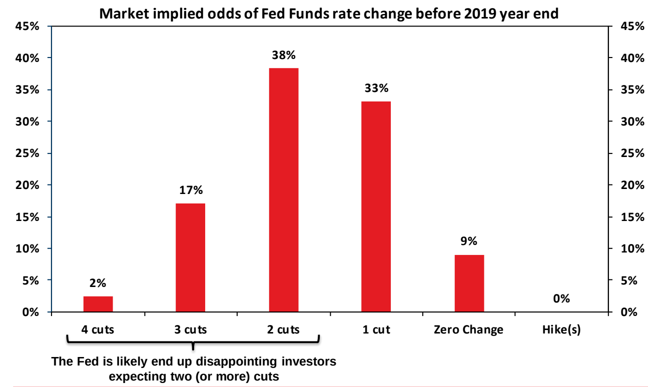


CIO Office (data via Refinitiv, NY Fed). *Neutral rate = Laubach & Williams R* estimate +2% constant inflation +/- a marging of error of 50 basis points.

We are nonetheless maintaining our tactical allocation between stocks and bonds at benchmark weight this month in view of the potential for higher volatility in the near-term. With markets still expecting substantially more easing before year-end, the Fed will either ultimately end up disappointing markets as we expect or will be forced to deliver in the face of more serious economic woes—two scenarios that are likely to generate more fluctuations than those observed recently (**Chart 11 and 12**).

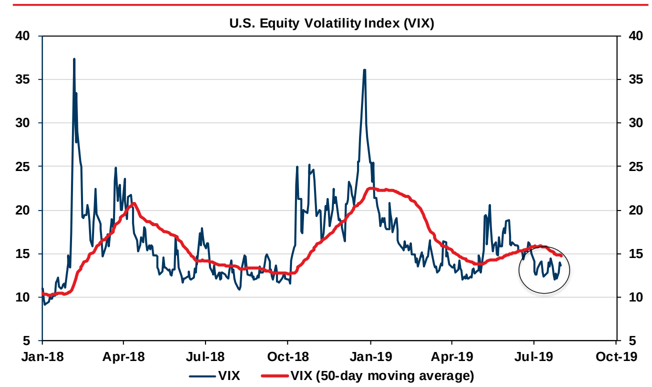
Geographically, we also stick with our preference for North American equities against those of Europe, Australasia, and the Far East (EAFE). The growth gap has widened in favour of the United States in recent months, leading to strong leadership from our neighbours to the south – as captured by our relative

11



CIO Office (data via Bloomberg). As of July 30, 2019.

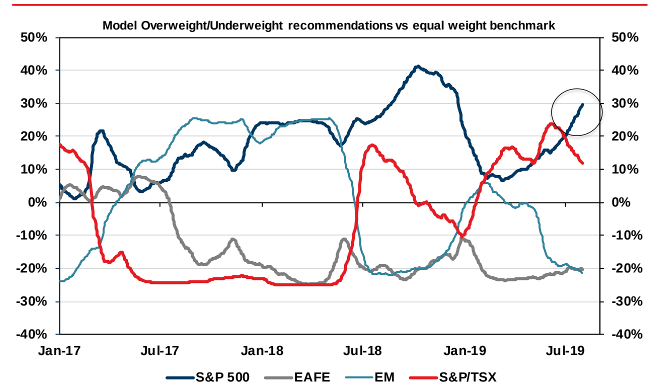
12 Will volatility resume in the coming months?



CIO Office (data via Bloomberg).

momentum model (**Chart 13**) – and we expect this trend to persist.

13 The gap is widening in favour of U.S. equities



CIO Office (data via Bloomberg).

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General

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