



## Slowly, but Surely?

### Highlights

- > World equities extended their solid year-to-date gains without much hassle in November, with global manufacturing indicators improving and Chinese/U.S. negotiators "on a glide path to a phase one agreement," in Peter Navarro's own words.
- > It may not be until 2020 before we know whether the two countries will manage to find common ground, but one thing is sure however: it would be very hazardous for President Trump to move forward with his tariffs threats on December 15, as these would be far more likely to be paid directly out of the pockets of U.S. consumers – the cornerstone of the U.S. economy.
- > Sentiment surveys continue to indicate that consumers are doing well and remain confident about the future. Contributing to these upbeat readings is a highly favourable labour market for workers. We should also mention the well-being of households' finances. Add this to a backdrop of largely accommodative monetary policies and you get a pretty positive outlook for the current business cycle.
- > Could it be that the U.S. administration decides to put all of the aforementioned elements at risk by stepping up trade tensions beyond a point of no return? Nothing is impossible when it comes to Donald Trump, but we would be very surprised to see him seriously endanger the health of the U.S. economy – the flagship argument of his presidency – less than a year away from the 2020 elections.
- > That said, a lot of optimism is already being expressed in the markets. Under these circumstances and having already increased our allocation to equities in October, we prefer to keep our asset mix unchanged at least until the rumours over a potential trade agreement give way to facts, and/or a market retreat provides an opportunity to deploy our cash allocation into risk assets.
- > Many investors are wondering what factors might drive bond yields higher from here. With Chair Jerome Powell making especially clear during a recent speech that the Fed is willing to let inflation run above its 2% target before even thinking about raising rates, we believe that both inflation expectations and term premiums will have to be closely monitored in the coming months.
- > Gold attracted a lot of attention this year, but now that rate cuts have been delivered, economic green shoots are accumulating, and an interim trade agreement is in the works, we must ask ourselves "how much upside could be left?" We note that speculators remain heavily exposed to the precious metal despite the slightly downward trend of recent months. All else being equal, this increases the risk of a correction in the short term, as has generally previously been the case under similar circumstances.
- > Easing concerns about global growth and trade uncertainties helped drive global equities higher in November, with U.S. stock valuations looking increasingly expensive. Does this mean that now is the time to flee the S&P 500? No. In fact, there is virtually zero-relationship between valuations and subsequent 3-month equity returns. What it means is rather that for this rally to continue, corporate earnings will have to take over and start rising again.

**Table 1 Global Asset Allocation**

Global Classes	Weights				
Cash					
Fixed Income					
Equities					
<b>Fixed Income</b>					
Federal					
Investment Grade					
High Yield (USD)					
Non-Traditional FI					
<b>World Equities</b>					
S&P/TSX					
S&P 500 (USD)					
MSCI EAFE (USD)					
MSCI EM (USD)					
<b>Factors and Alternative Investments</b>					
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

- > Despite a strong month for risk assets, safer government bonds (especially longer maturity ones) finished the period slightly up.
- > This category's laggard, preferred shares, having both fixed-income and equity-like properties, benefitted from increases in those asset classes and tipped back into positive year-to-date return territory.

### Canadian Equities

- > North American equities benefitted from increasing hopes that the "phase one" trade deal announced back in October could soon be struck between the U.S. and China.
- > As such, November was the S&P/TSX's best performing month since the market's January rebound at the start of this year.
- > Leading this advance was the IT sector, delivering its best year-to-date return since 2003.

### U.S. Equities

- > The S&P 500 also benefitted from an increase in trade optimism, closely matching its northern neighbour's strong performance.
- > While September and October played host to a resurgence in value stocks, November saw this trend stall, with gains in typical growth sectors such as Healthcare and Information Technology paralleled in more value-oriented sectors such as Financials and Industrials.

### Commodities

- > WTI was about to close out November near a two-month high, as slowing U.S. production growth helped support crude's rise, but rumours of leading OPEC+ members' unwillingness to extend cuts pulled the commodity back down.
- > To the north, WCS also followed suit, with a disruption in crude-by-rail shipments from a countrywide Canadian National Railway week-long strike only temporarily putting a dent in prices.
- > Meanwhile, investors' risk-on sentiment throughout November weighed on Gold's performance, as the commodity often sought out in times of heightened financial and economic stress fell below the \$1500 U.S./ounce mark, finishing the period near a four-month low.

### Foreign Exchange

- > The Greenback rose nearly 1% last month in lockstep with odds that FOMC members would vote to maintain rates in place at their next meeting, instead of the single cut that had previously been discounted.
- > The Loonie was not spared from the U.S. dollar's climb, losing ground throughout November and finishing the period trading at 1.32 USD.

**Table 2 Market Total Returns**

Asset Classes	November	Q4	YTD
<b>Cash (3-month T-bills )</b>	0.1%	0.3%	1.5%
<b>Bonds (FTSE/TMX Ovr. Univ.)</b>	0.5%	0.3%	8.2%
FTSE/TMX Short term	0.1%	0.3%	3.3%
FTSE/TMX Mid term	0.1%	0.0%	6.9%
FTSE/TMX Long term	1.3%	0.6%	15.7%
FTSE/TMX Government	0.5%	0.2%	8.0%
Federal	0.0%	0.0%	4.8%
Provincial	0.9%	0.5%	11.1%
Municipal	0.8%	0.6%	10.5%
FTSE/TMX Corporate	0.7%	0.6%	8.6%
AA+	0.2%	0.4%	4.9%
A	0.9%	0.7%	10.7%
BBB	0.7%	0.6%	9.5%
BoAML High-Yield (USD)	0.3%	0.5%	12.0%
Preferred Shares	1.2%	1.4%	1.0%
<b>Canadian Equities (S&amp;P/TSX)</b>	3.6%	2.7%	22.3%
Energy	5.2%	0.7%	14.4%
Industrials	3.8%	4.7%	25.0%
Financials	3.1%	3.5%	24.5%
Materials	-0.1%	2.8%	18.1%
Utilities	3.0%	2.0%	37.6%
Cons. Disc	5.5%	1.1%	19.3%
Cons. Staples	5.9%	1.1%	20.3%
Healthcare	-2.8%	-7.2%	-12.1%
IT	8.6%	7.4%	59.9%
Comm. Svc.	4.0%	2.5%	14.7%
REITs	2.5%	0.0%	25.7%
S&P/TSX Small Cap	2.7%	0.8%	9.9%
<b>US Equities (S&amp;P500 USD)</b>	3.6%	5.9%	27.6%
Energy	1.8%	-0.5%	5.5%
Industrials	4.5%	5.6%	29.4%
Financials	5.0%	7.6%	28.7%
Materials	3.2%	3.2%	20.9%
Utilities	-1.8%	-2.6%	22.1%
Cons. Disc	1.3%	1.6%	24.5%
Cons. Staples	1.3%	1.1%	24.7%
Healthcare	5.0%	10.4%	16.6%
IT	5.4%	9.5%	43.8%
Comm. Svc.	3.7%	6.9%	30.1%
REITs	-1.7%	-1.8%	27.3%
Russell 2000 (USD)	4.0%	6.6%	20.5%
<b>World Eq. (MSCI ACWI)</b>	2.5%	5.3%	22.9%
MSCI EAFE (USD)	1.1%	4.8%	18.8%
MSCI EM (USD)	-0.1%	4.1%	10.6%
<b>Commodities (CRB index)</b>	-0.8%	-0.3%	-5.6%
WTI Oil (US\$/barrel)	2.2%	2.0%	22.0%
Gold (US\$/ounce)	-3.2%	-0.8%	14.1%
Copper (US\$/tonne)	1.3%	2.6%	-1.8%
<b>Forex (DXY - US Dollar index)</b>	0.9%	-1.1%	2.2%
USD per EUR	-1.2%	1.1%	-3.5%
CAD per USD	0.9%	0.3%	-2.6%

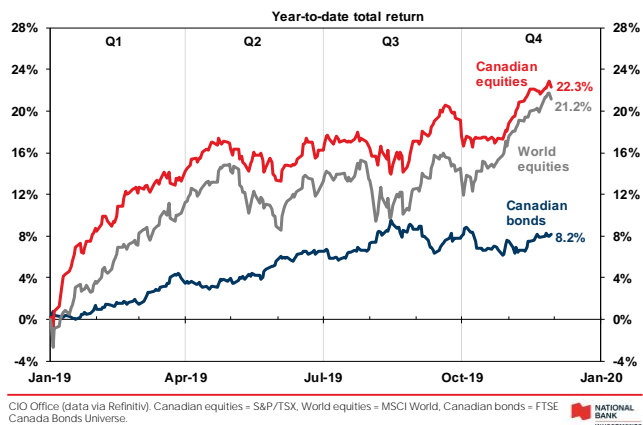
CIO Office (data via Refinitiv)

2019-11-29

### Slowly, but Surely?

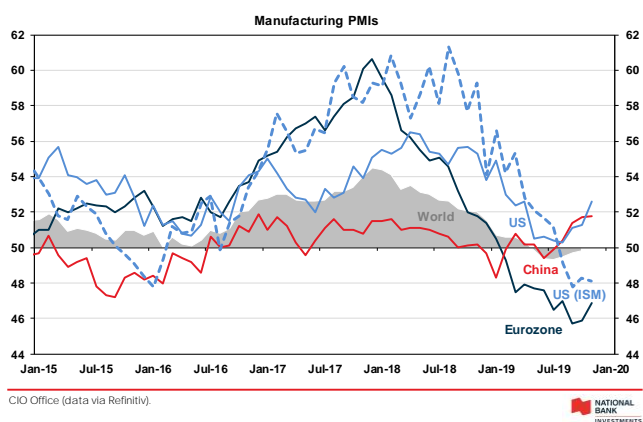
It was rather calm in November across most asset classes, with global equities extending their solid year-to-date gains without much hassle, and Canadian bonds holding steady within their recent trading range (Chart 1).

#### 1 Another solid month for risk assets...



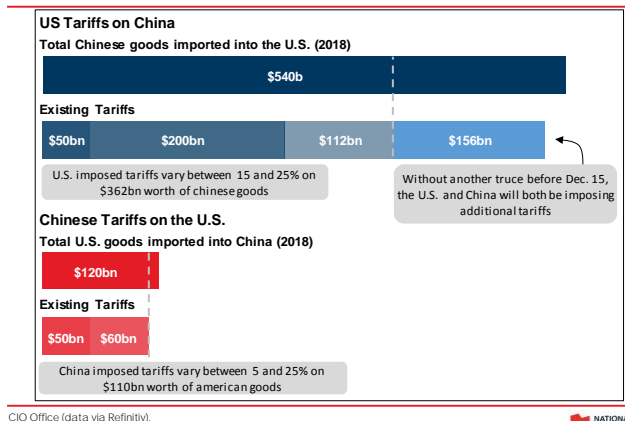
This comes on the heels of several global manufacturing indicators improving over the last month, in line with our expectations as discussed in our October report (Chart 2).

#### 2 ... as global manufacturing activity kept improving



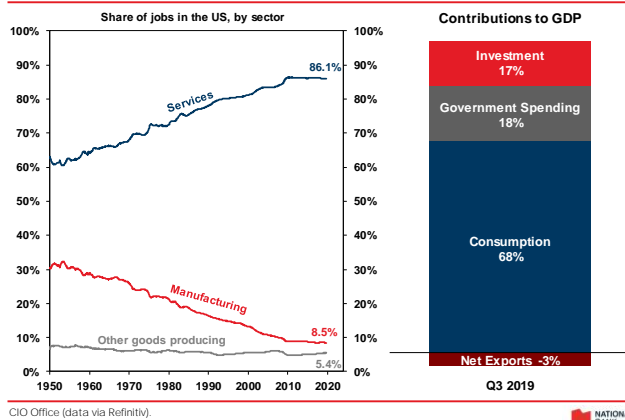
Beyond manufacturing activity, a key reason behind the sustained performance of stocks is undoubtedly the growing evidence that Chinese and U.S. negotiators are "on a glide path to a phase one agreement," in Peter Navarro's (White House trade adviser) own words. Points of contention seem to revolve around (1) provisions on intellectual property, (2) agricultural purchases and (3) tariff rollbacks. It may not be until 2020 before we know whether the two countries will manage to find common ground on these points. One thing is sure however, it would be very hazardous for President Trump to move forward with his threat to impose additional tariffs on \$156 billion USD worth of Chinese-made consumer goods on December 15 (Chart 3), ten days before Christmas, as these tariffs would be far more likely to be paid directly out of the pockets of U.S. consumers – the cornerstone of the U.S. economy.

#### 3 Will President Trump pull the trigger in December?



Indeed, while we tend to more closely cover manufacturing activity given its tight correlation with equity markets, it is rather the consumer that is the main engine of growth for the U.S. economy. Case in point, jobs in the manufacturing sector represent only 8.5% of all payrolls, compared to 86.1% for the service sector. What's more, if we look at the composition of U.S. GDP, we see that 68% comes from personal consumption (Chart 4).

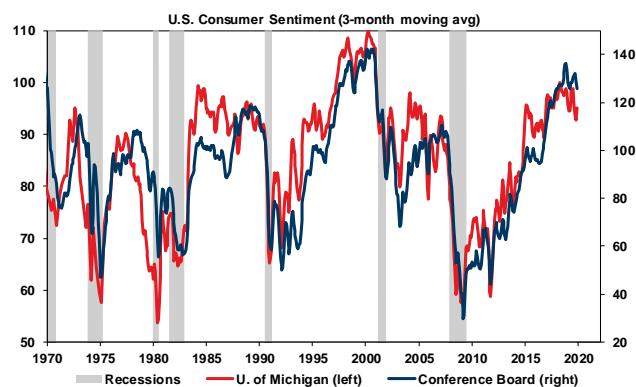
#### 4 The U.S. consumer is the cornerstone of the economy



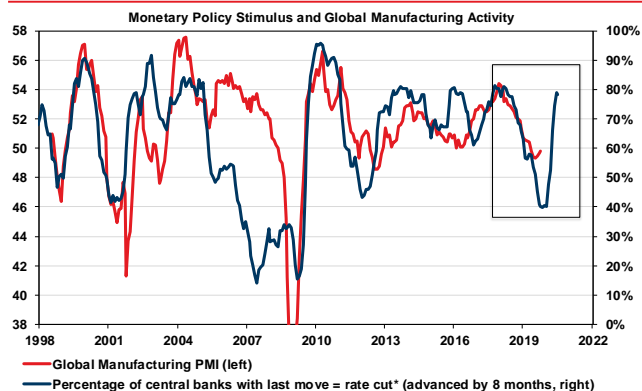
Sentiment surveys continue to indicate that consumers are doing well and remain confident about the future, with both the Conference Board and University of Michigan measures firmly anchored in the upper section of their historical range (Chart 5, next page).

Contributing to these upbeat readings is a highly favourable labour market for workers, with no less than 1.1 million more jobs to fill than there are unemployed people (Chart 6, next page).

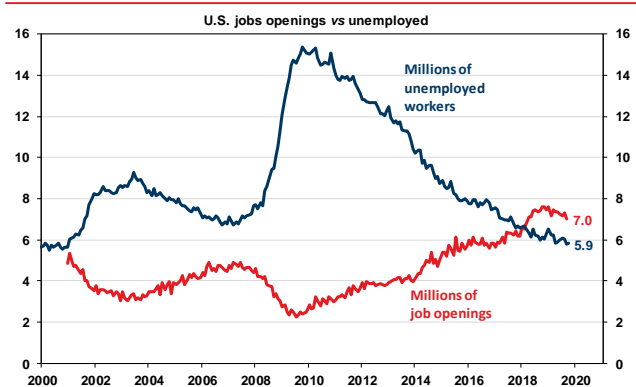
We should also mention the well-being of household finances, with the ratio of debt-to-GDP having shrunk by almost 25% since the last recession and the fraction of disposable income allocated to debt servicing now at a 40-year low (Chart 7, next page).

**5 Consumer sentiment remains strong...**

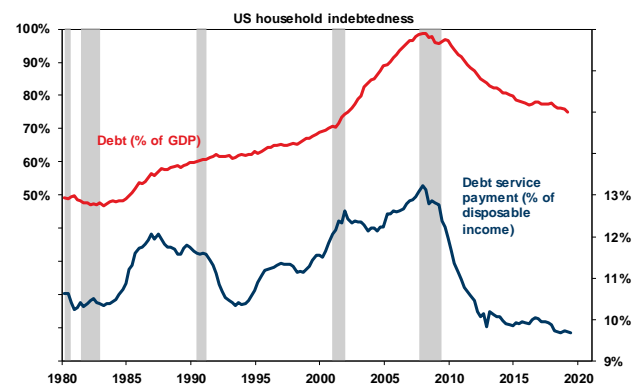
CIO Office (data via Refinitiv).

**8 Monetary policy stimulus should support global growth**

CIO Office (data via Refinitiv). \*38 central banks.

**6 ... backed by a highly favourable labour market...**

CIO Office (data via Refinitiv).

**7 ... and healthy household finances**

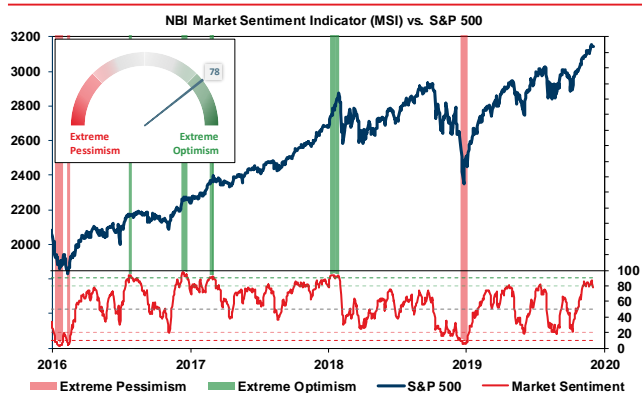
CIO Office (data via Refinitiv).



Overall, the mix of rebounding manufacturing activity, confident consumers, prime labour market conditions, robust household finances, and accommodative monetary policies – 76% of global central banks have cut rates over the last few months (Chart 8) – bodes well for the sustainability of the current business cycle.

Could it be that the U.S. administration decides to put all of the aforementioned elements at risk by stepping up trade tensions beyond a point of no return? Nothing is impossible when it comes to Donald Trump, but we would be very surprised to see him seriously endanger the health of the U.S. economy – the flagship argument of his presidency – less than a year away from the 2020 elections.

That said, it should be noted that a lot of optimism is already being expressed in the markets, as measured by our sentiment indicator (Chart 9). Under these circumstances and having already increased our allocation to equities in October, we prefer to keep our asset mix unchanged at least until the rumours over a potential trade agreement give way to facts, and/or a market retreat provides an opportunity to deploy our cash allocation into risk assets.

**9 A lot of optimism is being expressed in the markets**

CIO Office (data via Refinitiv).

**Fixed Income: Change of Driver**

U.S. 10-year Treasury yields inched slightly higher in November, pursuing their modest upward trend observed over the last three months (Chart 10, next page).

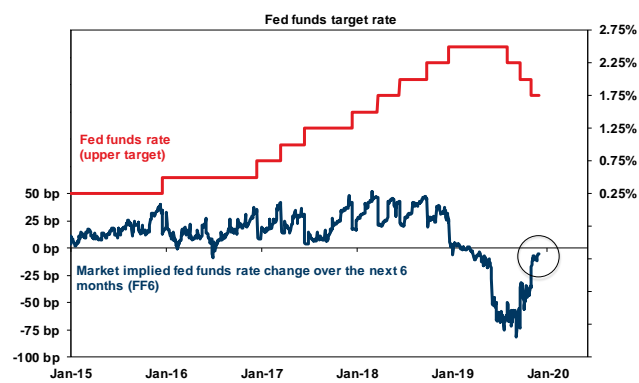
Many investors are wondering what factors might drive bond yields higher from here, if any. We would be surprised to see central banks play a significant role in this regard, as it has

**10** The upward trend continues for 10-year Treasury yields

CIO Office (data via Refinitiv).



become increasingly clear that the Federal Reserve will remain on the sidelines for several more months, having just completed a round of three rate cuts. Furthermore, this belief seems shared by market participants (Chart 11).

**11** The Fed should remain on the sidelines for several months

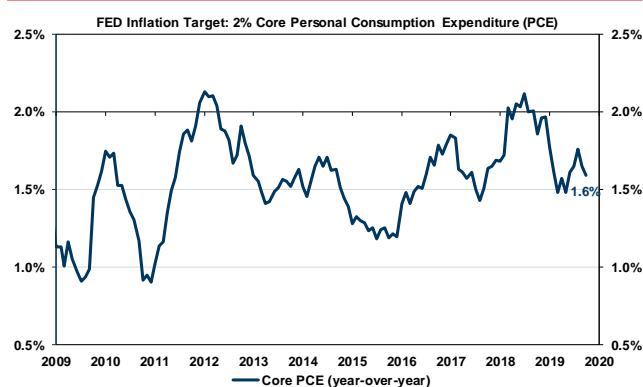
CIO Office (data via Refinitiv, Bloomberg).



Indeed, Chair Jerome Powell has made it especially clear during a recent speech that the Fed is willing to let inflation run above its 2% target before even thinking about raising rates. The main reason is nearly a decade of below-target inflation realisations (Chart 12) and the concern that the Japanese/European experience may also occur in the United States:

*Around the world [...] we have seen that inflation running persistently below target can lead to an unhealthy dynamic in which inflation expectations drift down, pulling actual inflation further down. Lower inflation can, in turn, pull interest rates to ever-lower levels. The experience of Japan, and now the Euro area, suggests that this dynamic is very difficult to reverse, and once under way, it can make it harder for a central bank to support its economy by further lowering interest rates.*

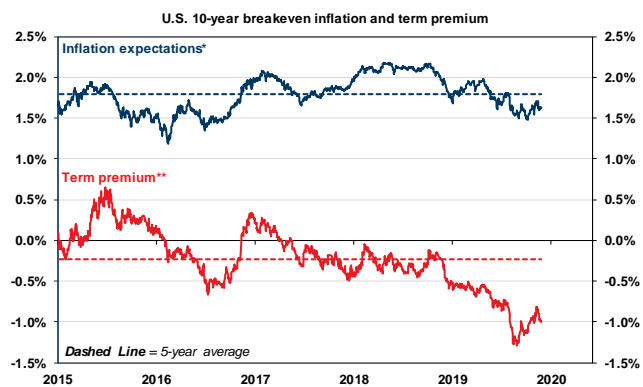
- Jerome Powell, November 25, 2019

**12** Below-target inflation risks becoming the norm

CIO Office (data via Refinitiv).



Therefore, a key factor to be closely monitored in the coming months will be the evolution of inflation expectations, which currently stand 17 basis points below their last five-year average. If our constructive economic outlook proves right, this measure should move higher, thereby exerting upward pressure on bond yields. What's more, let us not forget the potential impact of the term premium, the main factor behind the rebound in Treasury yields in recent months. There is clearly still room for a reversion to the mean, but this remains largely conditional on a positive outcome on the trade front and a reacceleration in global economic activity (Chart 13).

**13** Watch for inflation expectations AND the term premium

CIO Office (data via Refinitiv). \*10-year breakeven inflation rate. \*\*ACM 10-year term premium.

**Commodities: What's Next for Gold?**

Gold attracted a lot of attention this year, and for good reason. For starters, its 31% rally from the August 2018 lows all the way up to early September 2019 highs was enough to generate interest, in and of itself (Chart 14, next page).

But beyond price action, a backdrop of (1) rising geopolitical uncertainty, (2) slowing global growth, (3) monetary policy easing, and (4) central bankers' willingness to let inflation run hot seemed almost tailor-made for the bullion to appreciate. However, now that rate cuts have been delivered, economic green shoots are accumulating, and an interim trade agreement is in the works, we must ask ourselves "how much upside could be left?"

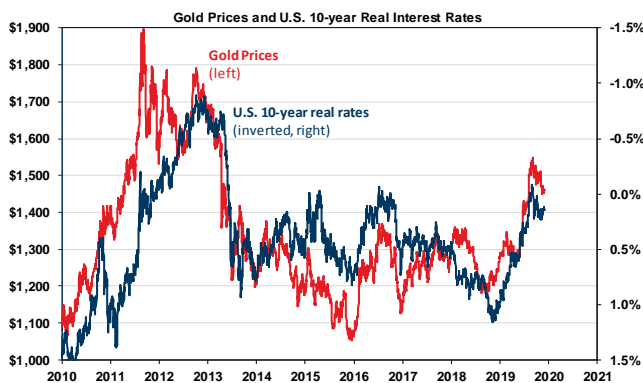


**14 Gold attracted a lot of attention this year...**

CIO Office (data via Refinitiv).



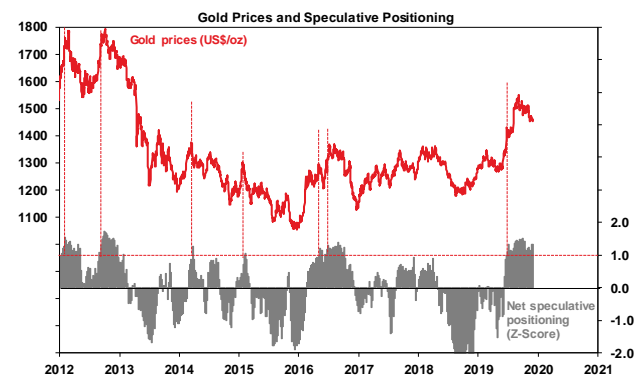
To answer this question, it is worth analyzing gold's twin brother: U.S. real interest rates. As argued in the fixed income section, both the term premium and breakeven inflation rates are likely to put upward pressure on nominal yields in the months ahead. However, when it comes to real yields, it becomes important to know which of these two measures will move the most.<sup>1</sup> Lately, changes in term premiums, which tend to track investors' risk appetite, have far outweighed rising inflation expectations. This explains why real yields have gone up... and gold prices have come down (Chart 15).

**15 ... but real yields could weigh on the precious metal...**

CIO Office (data via Refinitiv).



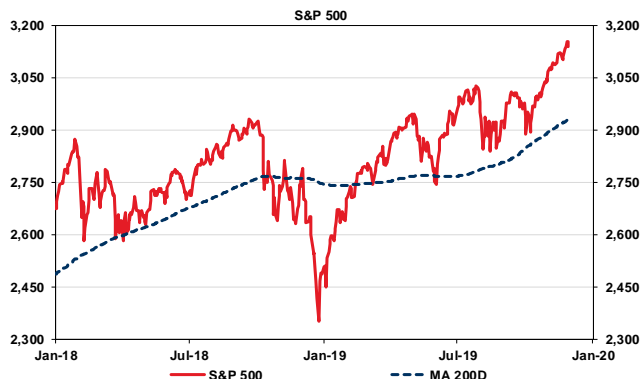
Looking ahead, rising inflation and accommodative monetary policies should help put a floor on the bullion, but it is clear that a substantial breakthrough in trade negotiations could send real yields higher at the expense of gold. In addition, it should be noted that speculators remain heavily exposed to the precious metal despite the slight downward trend of recent months. All else being equal, this increases the risk of a correction in the short term, as has generally previously been the case under similar circumstances (Chart 16).

**16 ... while speculators remain heavily exposed**

CIO Office (data via Refinitiv).

**Equities: Time for Earnings to Pick Up**

Easing concerns about global growth and trade uncertainties helped drive global equities higher in November, with the S&P 500 pushing its record high further up, outperforming most other equity indices (Chart 17).

**17 New record high for U.S. equities in November...**

CIO Office (data via Refinitiv).

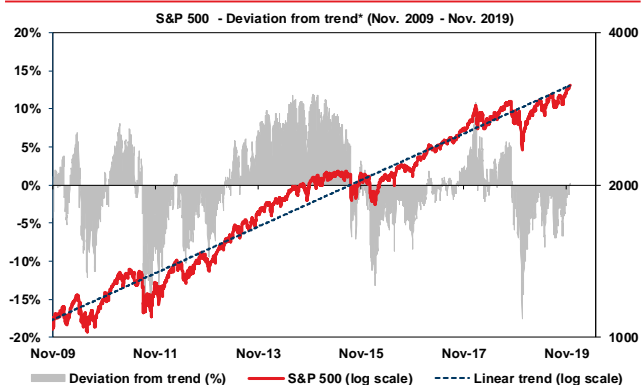


Now, this all-time high may not be as spectacular – or worrying – as it looks if we take a step back, whereas it simply represents a return on the linear trend of the last ten years for the U.S. stock market (Chart 18, next page).

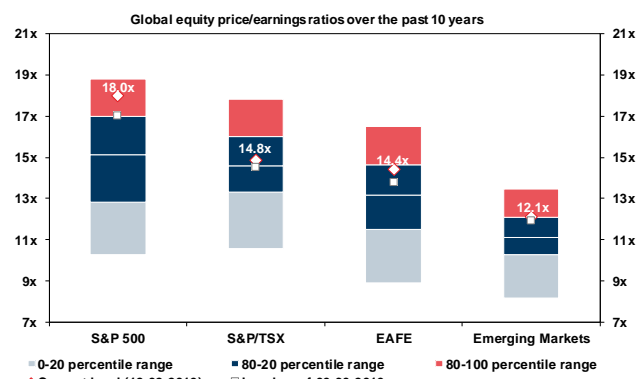
But as regards valuations, we must acknowledge that multiples are starting to look a little expensive, especially in the U.S. where the price-earnings ratio has increased by a full point in November alone (Chart 19, next page).

Does this mean that now is the time to flee U.S. equities? No. In fact, there is virtually zero-relationship between valuations and subsequent 3-month equity returns (Chart 20, next page).

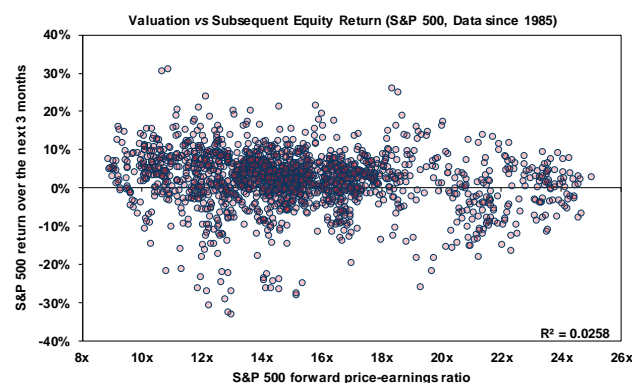
<sup>1</sup> This follows the assumption that nominal yields can be broken down into three components: (i) the expected path of short-term real monetary policy (MP) rates, (ii) the term premium, and (iii) expected inflation. Consequently, Real Yields = E(Path of real MP) + Term Premium - E(Inflation).

**18 ... marking a return to the linear trend of the last 10 years**

CIO Office (data via Refinitiv). \* Linear regression in time on the logarithm of the S&P 500 (from November 2009 to November 2019).

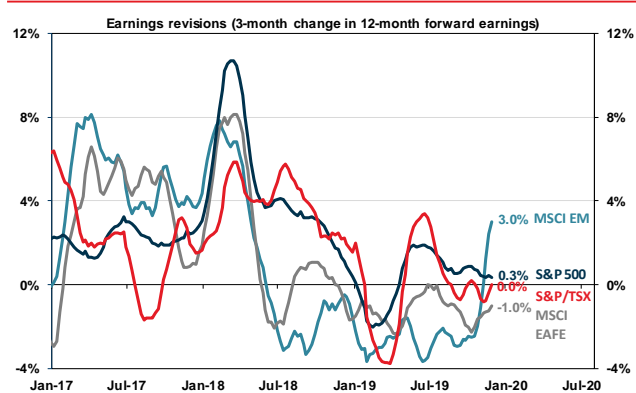
**19 Valuations are starting to look a little expensive...**

CIO Office (data via Refinitiv).

**20 ... which doesn't mean it's time to sell...**

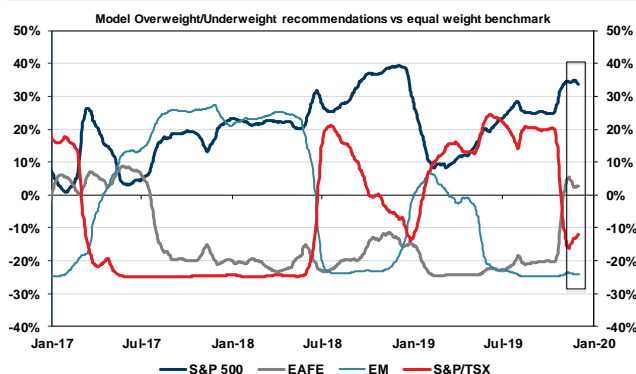
CIO Office (data via Refinitiv).

What it means is rather that for this rally to continue, corporate earnings will have to take over and start rising again. At this point, only emerging markets seem to be changing gears in this regard, having benefitted from positive earnings revisions for the first time since June 2018 (Chart 21).

**21 ... but earnings will have to take over**

CIO Office (data via Refinitiv).

If a trade agreement comes before us in December, it is likely that this could lead to a resurgence in emerging market leadership. Yet, that's something we deem too uncertain for now, while our relative momentum model remains significantly underweight in the region (Chart 22).

**22 No significant change of leadership in November**

CIO Office (data via Refinitiv).

Under these circumstances, we remain confident with our current geographical positioning and stand ready to reassess as the geopolitical and economic backdrop evolves.

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**General**

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