NATIONAL BANK INVESTMENTS

ASSET ALLOCATION STRATEGY

February 2019

The dust has settled… now what?

- After a stormy year-end for global markets, the dust finally settled in January as fears of an impending recession eased, largely due to the Federal Reserve's realignment to a *wait-and-see* stance.
- So, now what? While our outlook of modest deceleration in global growth and prudent central banks has not changed, other key risks remain as topical as we argued last month.
- Therefore, and following a near-perfect stretch of news in January, we choose to trim our overweight to stocks by a fraction to better align our tactical allocation with the degree of volatility expected. This move is also consistent with the recommendation of our A3 model, which keeps pushing for mild equity overweight.
- In addition, we are making changes to our geographical mix by reducing our allocation in U.S. equities to the benefit of both emerging markets and Canadian equities. The end-result is an overall cheaper portfolio on a price/earnings basis, with reduced expected volatility, and that is better-aligned with the weakening of the U.S. dollar which we expect in the upcoming quarters.
- Our expectations of prudent central banks have materialized recently. That implies that they shouldn't act as headwinds for risk assets in the coming months, and that Chinese monetary and fiscal measures should further support growth. It also means that there should be less upward pressure on global government bond yields, hence why we continue to recommend a duration closer to benchmark for fixed-income portfolios.
- An easier tone from a Federal Reserve well ahead of its peers, the U.S. economy losing steam after a record year propelled by the largest tax cuts in over 30 years, a paralyzed Congress, and budget deficits destined to deepen – the stage seems to be increasingly prone for U.S. dollar depreciation this year. Such context is typically concomitant with emerging market outperformance and rising commodity prices.
- With equity valuations closer to historical averages, companies' ability to grow their bottom line is rising in importance. Now that half of the Q4/2018 earnings season is behind us, it seems less and less clear that the S&P 500 will fare better in this respect. Furthermore, U.S. equities have exhibited significantly higher volatility than their peers and greater vulnerability to changes in investor sentiment in recent months, an observation that is likely to persist in 2019.
- As for emerging markets, the shift in leadership in their favour has become apparent in our relative momentum model, which now recommends overweight positions in the region (as well as in Canada). Sino-U.S. trade tensions remain a threat, but the U.S. Administration should perhaps be reminded that Chinese policymakers have the enviable advantage of having the flexibility to quickly adjust monetary and fiscal policy as needed.
- In the commodity space, we expect the WCS spread to remain stable for now, allowing Canadian oil prices to slowly increase along with their international peers by the end of the year

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

- Both U.S. and Canadian 10-year government bond yields edged lower in January, benefitting from the significant shift in tone from global central banks and leading to a good start to the year for fixed-income benchmarks.
- High-yield U.S. corporate bonds fared especially well, up 4.6% after one month of 2019.

Canadian Equities

- In what can only be described as a strong start to the year, Canada's main stock index climbed 8.7% in January, lifted in part by rising oil prices, and outperforming both the S&P 500 and emerging markets over the period.
- Healthcare rocketed higher this month (up 43.3%), thanks to high-flying cannabis stocks that regained investors' focus in the wake of the equity market recovery.
- Energy, the second-largest sector in the S&P/TSX, benefitted greatly from oil's performance, as close to three-quarters of its constituents ended the month up for a combined return of 10.7%**.**

U.S. Equities

- In contrast with last year's disappointing performance, the S&P 500 grew an impressive 8% this month supported by a mix of early-in-the-season earnings' beats, valuations rising back toward their long-term mean, and a more dovish Fed.
- Specifically, Energy, and Industrials took the lead (11.1%**,** and 11.4%, respectively) while the more defensive Utilities, and Healthcare sectors lagged (3.4%, and 4.8%, respectively).

Commodities

- On the back of a December agreement by OPEC members to cut output by 1.2 million barrels per day and renewed optimism for global growth, this month saw the largest rally in the WTI benchmark (19.2%) since April 2016.
- Gold also edged upward in January, gaining another 3.2%, and breaking through the $1300 mark late in the month, bolstered by a weaker U.S. dollar and lower real yields.

Foreign Exchange

- Riding on the coattails of rising oil prices and better-than-expected Canadian economic figures, the Loonie gained ground in January, delivering its largest monthly increase (3.8%) since July 2017.
- The British pound also rallied last month, with the prospect of a hard Brexit seeming less and less likely, although the ride up was anything but smooth.
- The Federal Reserve's change to a much more dovish tone and the subsequent recovery in investors' risk appetite has helped to push down the U.S. dollar index for a second consecutive month.

Table 2 Market Total Returns

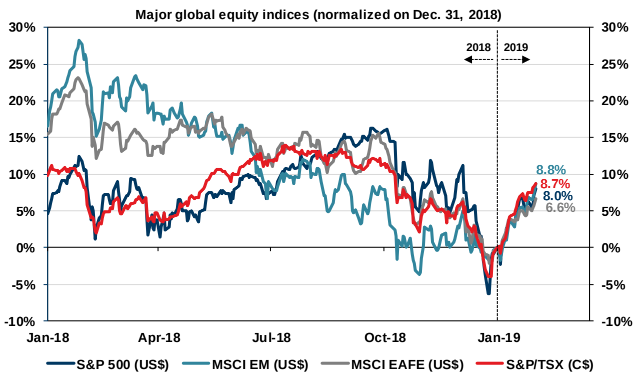
Asset classes	January	12 months	2018
Cash (3-month T-bills)	0.1%	1.4%	1.4%
Bonds (FTSE/TMX Ovr. Univ.)	**1.3%**	**3.6%**	**1.4%**
FTSE/TMX Short term	0.7%	2.8%	1.9%
FTSE/TMX Mid term	1.4%	4.6%	1.9%
FTSE/TMX Long term	2.2%	3.9%	0.3%
FTSE/TMX Government	1.2%	3.8%	1.5%
Federal	0.7%	3.9%	2.4%
Provincial	1.7%	3.7%	0.7%
Municipal	1.5%	3.5%	0.9%
FTSE/TMX Corporate	1.7%	3.0%	1.1%
AA+	1.1%	3.1%	1.8%
A	1.9%	2.8%	0.5%
BBB	2.0%	3.1%	1.0%
BoAML High-Yield (USD)	4.6%	1.6%	-2.3%
Preferred Shares	-0.5%	-9.8%	-7.9%
Canadian Equities (S&P/TSX)	**8.7%**	**0.5%**	**-8.9%**
Energy	10.7%	-4.4%	-18.3%
Industrials	7.4%	6.7%	-2.4%
Financials	8.5%	-2.3%	-9.3%
Materials	6.7%	-2.6%	-9.3%
Utilities	6.3%	1.2%	-8.9%
Cons. Disc	10.7%	-6.7%	-16.0%
Cons. Staples	3.5%	7.5%	2.0%
Healthcare	43.3%	25.6%	-15.9%
IT	10.0%	17.9%	13.0%
Telecom	4.6%	8.6%	-0.8%
REITs	8.0%	11.2%	2.0%
S&P/TSX Small Cap	7.7%	-10.0%	-18.2%
US Equities (S&P500 USD)	**8.0%**	**-2.3%**	**-4.4%**
Energy	11.1%	-12.3%	-18.1%
Industrials	11.4%	-8.3%	-13.3%
Financials	8.8%	-11.1%	-13.0%
Materials	5.5%	-13.6%	-14.7%
Utilities	3.4%	11.1%	4.1%
Cons. Disc	10.3%	1.7%	0.8%
Cons. Staples	5.2%	-5.1%	-8.4%
Healthcare	4.8%	4.7%	6.5%
IT	7.0%	-0.9%	-0.3%
Telecom	10.4%	-4.0%	-12.5%
REITs	10.8%	10.4%	-2.2%
Russell 2000 (USD)	11.2%	-4.8%	-12.2%
World eq. (MSCI ACWI)	**7.9%**	**-7.0%**	**-8.9%**
MSCI EAFE (USD)	6.6%	-12.1%	-13.4%
MSCI EM (USD)	8.8%	-13.9%	-14.2%
Commodities (CRB index)	**0.9%**	**-6.9%**	**-5.4%**
WTI Oil (US$/barrel)	19.2%	-16.9%	-25.3%
Gold (US$/ounce)	3.2%	-1.4%	-1.7%
Copper (US$/tonne)	3.4%	-13.1%	-17.5%
Forex (DXY - US Dollar index)	**-0.6%**	**7.2%**	**4.4%**
USD per EUR	0.4%	-7.9%	-4.8%
CAD per USD	-3.8%	6.6%	8.4%

Source: Datastream 1/31/2019

The dust has settled…

After a stormy year-end for global markets, the dust finally settled in January, with major global equity indices up significantly since the start of 2019 (**Chart 1**).

1 Global equities got off to a flying start …

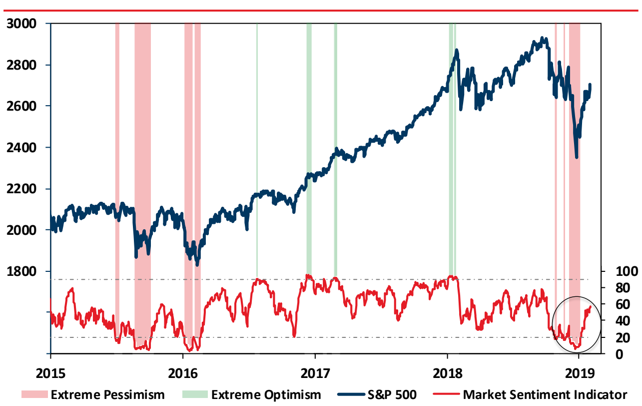


CIO Office (data via Refinitiv)

Concomitantly, fears of an impending recession appear to have eased in recent weeks, largely due to the U.S. Federal Reserve's realignment to a *wait-and-see* stance. Chairman Jerome Powell's emphasis on his intention to remain "patient and flexible" was an obviously positive development for risk assets, especially since an overly aggressive Fed was one of the three key 2019 risks listed in our year's first edition of the Asset Allocation Strategy report. Indeed, it seems that this risk has diminished, at least for the coming months (more on that in the Fixed Income section).

Last month, we also argued that "the combination of depressed stock valuations and heightened fear increases the chances of a bounce in risk assets over the short-term," a statement backed by the simple fact that our *Market Sentiment Indicator* hovered in *extreme pessimism* territory for most of December – a situation that rarely lasts so long. The latter has now effectively recovered and presently stands at a level considered neutral (**Chart 2**).

2 … as investor sentiment recovered

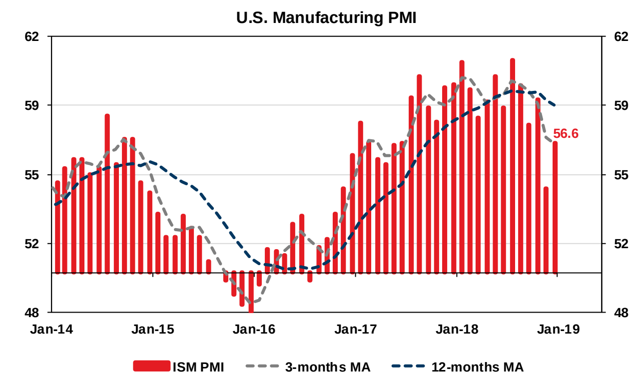


CIO Office (data via Refinitiv and Bloomberg)

…now what?

So, now what? For starters, our outlook of modest deceleration in global growth and prudent central banks has not changed. The fact that the 2018 Chinese GDP growth effectively dropped to its slowest annual rate since 1990 (+6.6%) was hardly news considering that many indicators predicted such a figure for a while. In the U.S., the January ISM Manufacturing PMI report came out strong, still painting a solid economic backdrop, although more modest than last year (**Chart 3**).

3 The PMI continues to paint a solid economic backdrop



CIO Office (data via Refinitiv)

Nevertheless, these prospects remain just as fragile as we argued last month, with our two other key risks for 2019 (China's capacity to manage its structural slowdown and an unpredictable White House) ever more topical as we get closer to the March 1 deadline set by the U.S. Administration to reach a new trade deal with China.

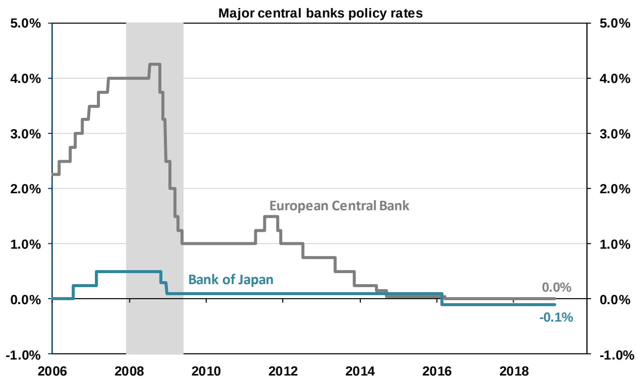
Therefore, and following a near-perfect stretch of news in January, we are choosing to trim our overweight to stocks by a fraction to better align our tactical allocation with the degree of volatility expected. This move is also consistent with the recommendation of our A3 model, which keeps pushing for a mild equity overweight. In addition, we are making changes to our geographical mix by reducing our allocation in U.S. equities (from overweight to neutral) to the benefit of both emerging markets (from neutral to overweight) and Canadian (from neutral to overweight) equities. More details to come in the following sections.

Fixed Income: Central Banks' *Route Recalculation*

Hearing one's GPS announce a "route recalculation" is rarely good news when driving, but in the case of central banks' monetary policy guidance, it certainly is. Indeed, monetary policymakers have been quite vocal lately, yielding the dovish bias that market participants asked for following the stormy 2018 year-end.

For instance, the Bank of Japan reduced its inflation forecast on January 23, thereby pledging to keep its massive asset purchase program alive for the foreseeable future. The European Central Bank followed in the same vein the day after, with its President, Mario Draghi, stating that "when markets place the first rate hike in 2020, they are using the state contingent part of our forward guidance … and it shows that they have understood our reaction function." Policy rates in these regions have been on the floor for almost two years now, and it seems that they are not coming up any time soon (**Chart 4)**.

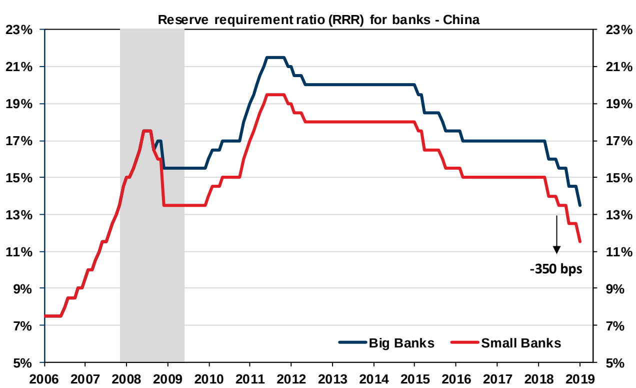
4 The ECB and BoJ still subject to caution …



CIO Office (data via Refinitiv)

Chinese authorities have also been very active, starting with a shift in the official monetary policy description back in December from "prudent and neutral" to "prudent with appropriate looseness and tightness." A number of measures then followed, including tax cuts and targeted actions supporting liquidity, such as an additional 100 bps cut in banks' reserve requirement ratios (RRR) – thereby bringing to 350 bps the total RRR cuts over the last year (**Chart 5**).

5 … the PBoC increasingly stimulative …



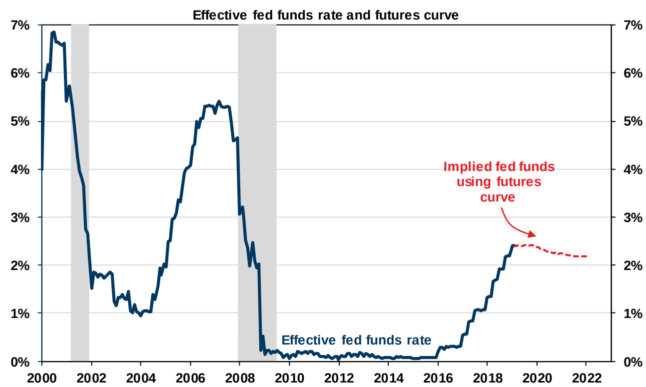
CIO Office (data via Refinitiv)

But the biggest route change has arguably been from Fed Chairman Jerome Powell moving from qualifying the balance sheet run-off as being on "autopilot" after hiking rates unreservedly in December to "we can be patient and flexible, and wait and see what does evolve*"* during a Q&A session at the Economic Club of Washington, D.C., on January 10. The Fed later formalized these comments in the January 30 FOMC statement:

> *"In light of global economic and financial developments and muted inflation pressures, the Committee will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate to support these outcomes.*
>
> *The Committee is prepared to adjust any of the details for completing balance sheet normalisation in light of economic and financial developments,"*
>
> \- *FOMC Statement, January 30, 2019*

As a result, markets continue to believe that the Fed is done with hiking rates (**Chart 6**).

6 … and the Fed as prudent and patient as ever



CIO Office (data via Refinitiv and Bloomberg)

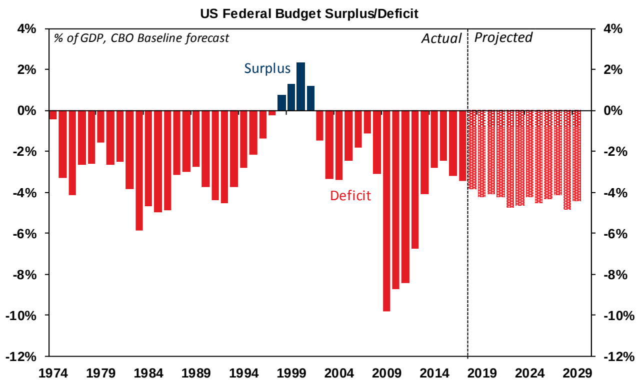
So, what can we conclude from this *route recalculation*? That central banks shouldn't act as headwinds for risk assets in the coming months, and that Chinese monetary and fiscal measures should further support growth. It also means that there should be less upward pressure on global government bond yields, hence why we continue to recommend a duration closer to benchmark for fixed-income portfolios.

Currencies: A Fragile King Dollar

With an easier tone from a Federal Reserve well ahead of its peers, the U.S. economy losing steam after a record year propelled by the largest tax cuts in over 30 years, a paralyzed Congress, and budget deficits destined to expand according to *Congressional Budget Office* projections updated this week (**Chart 7**, next page) – the stage seems to be increasingly prone for U.S. dollar depreciation this year.

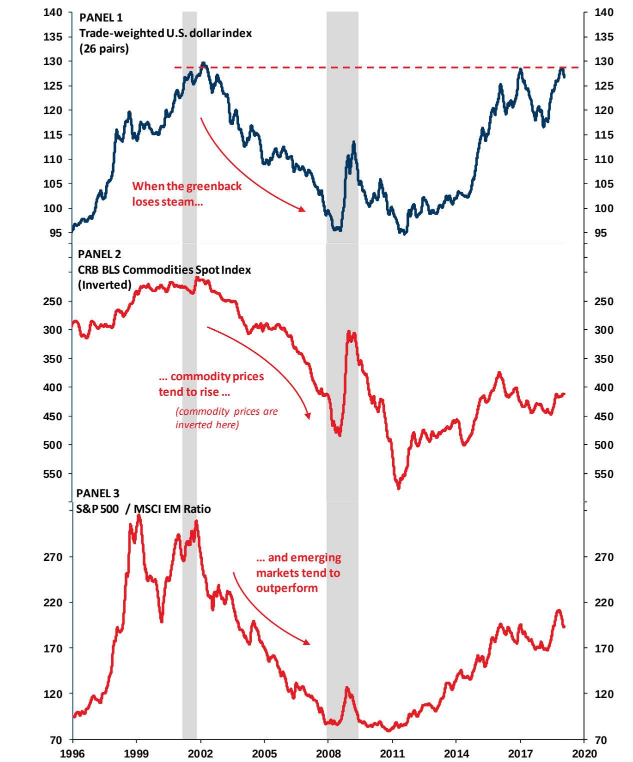
To put things into perspective, the trade-weighted U.S. dollar index – which comprises 26 currencies from both developed and emerging countries – reached a high point during last December's market turmoil, stopping almost exactly at the

7 U.S. budget deficits destined to expand



CIO Office (data via Refinitiv)

8 What happens when the greenback looses steam?



CIO Office (data via Refinitiv)

same point as the March 2002 and January 2017 high water marks (**Chart 8, Panel 1**).

Should the dollar effectively continue to roll back, implications would be numerous. For instance, commodity prices and the Greenback have historically been negatively correlated, an observation largely explained by the fact that most commodities are quoted in dollars and therefore can be perceived much like a currency pair. To put it simply, the lower the USD, the better the chances of higher commodity prices (**Chart 8, Panel 2**).

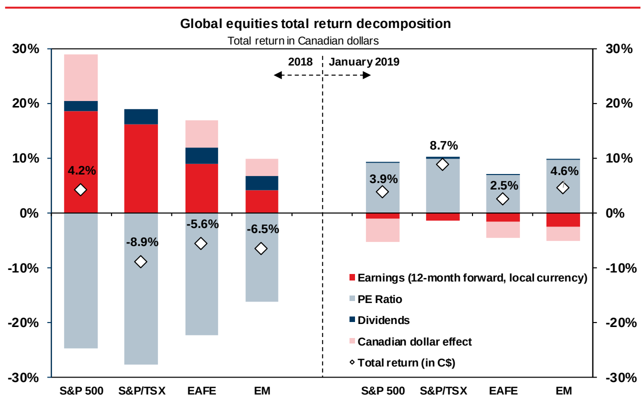
A second element that generally follows the Greenback's direction hand-in-hand is emerging markets' (EM) leadership over developed markets (DM), with EM generally doing better when the dollar weakens. Obviously, causal relationships in macroeconomics are almost always two-way. But, a weaker USD undoubtedly implies a lower cost of servicing dollar-denominated debt, an important source of financing for many EM companies still to this day. In short, the lower the USD, the better the chances of emerging markets' outperformance (**Chart 8, Panel 3**).

At present, the main risk to our prospects for a weaker dollar is a sharp acceleration in Sino-US trade tensions, in which case the Greenback safe-haven status would likely push it higher. But President Trump should perhaps be reminded that an effective way to shrink his trade deficit is not through tariffs, but simply by letting his king dollar depreciate. In this regard, U.S. Treasury Secretary Steven Mnuchin did not hesitate to break with the pro-dollar tradition of his predecessors by stating that "a weaker dollar is good for us as it relates to trade and opportunities" last week in Davos.

Equities: Back on their Feet

Global Equity indices all bounced back quite significantly in January, with Canadian stocks taking the leadership position and the EAFE region lagging behind – a stark contrast with last year. Sources of return are also a mirror-image of 2018, entirely driven by ratio expansion, while earnings revisions and the Canadian dollar appreciation both had a slightly negative impact on performance (**Chart 9**).

9 January 2019: A stark contrast to 2018



CIO Office (data via Refinitiv)

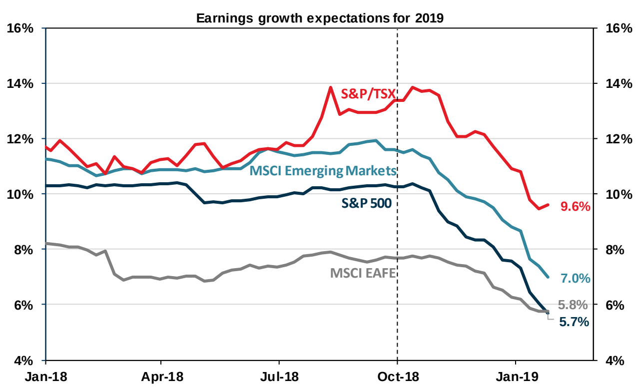
A modest recovery in depressed equity valuations was overdue, but we shouldn't expect much from them at this point and this late in the cycle. It is rather the ability of companies to grow their bottom lines that matters, and although the decent Q4/2018 earnings' season (**Chart 10**) has helped the rebound as we expected last month, it is doing little to stop the persistent downward revision to estimates for this year. That holds especially true in the U.S. (**Chart 11**).

10 A decent Q4/2018 earnings season so far …

	Earnings Summary - S&P 500				Q4/2018 YoY%
	% Reported	% Beat	% Met	% Missed	Blend*
S&P 500	43%	71%	7%	22%	15.0%
Financials	65%	64%	0%	36%	16.7%
Industrials	62%	81%	2%	16%	26.8%
Materials	52%	54%	0%	46%	4.0%
Technology	46%	90%	3%	6%	9.2%
Health Care	45%	82%	7%	11%	12.8%
Staples	39%	54%	15%	31%	3.4%
Discretionary	31%	75%	0%	25%	14.1%
Real Estate	28%	22%	56%	22%	6.4%
Energy	27%	63%	25%	13%	63.6%
Comm. Sev.	23%	67%	17%	17%	20.1%
Utilities	15%	25%	50%	25%	-10.8%

CIO Office (data via Thomson Reuters)
*Blends actual EPS growth with expectations for those yet to report.

11 … didn't stop downward revisions of expectations

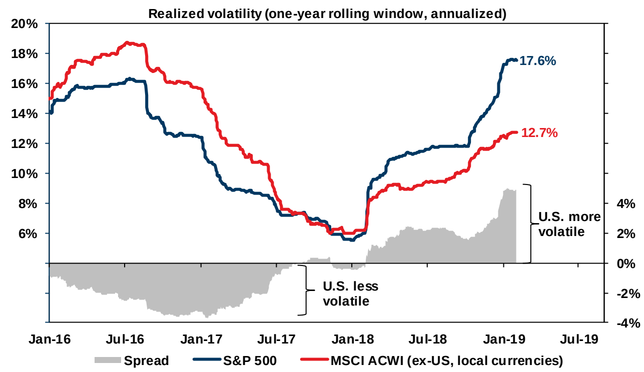


CIO Office (data via Refinitiv)

Furthermore, U.S. equities have exhibited significantly higher volatility than their peers and greater vulnerability to changes in investor sentiment in recent months, an observation that is likely to persist in 2019 given the evermore unpredictable and fractured Washington (**Chart 12**).

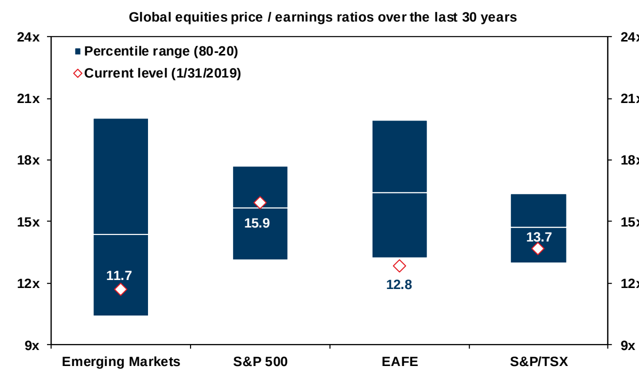
There is also a very fundamental reason behind our expectation of greater volatility in the U.S.: the simple fact that the S&P 500 is the only index with valuations above its last 30-year average. This implies more downside risk, should things turn sour (**Chart 13**).

12 The S&P 500 leads… in terms of volatility…



CIO Office (data via Refinitiv). Annualized standard deviation of weekly returns over a rolling 260 day window.

13 … and in terms of price/earnings ratio



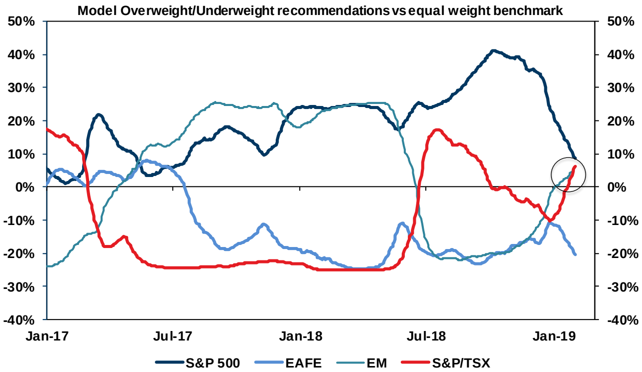
CIO Office (data via Refinitiv)

For their part, emerging markets are certainly not as cheap as they were back in December. However, the two conditions we outlined in previous reports for us to return to an overweight position began to materialize, namely (1) a reversal signal from our relative momentum model and (2) some clarity over trade negotiations.

Indeed, the shift in leadership out of the U.S. is currently clearly visible in our relative momentum model, which now recommends overweight positions both in Canada and emerging markets (**Chart 14**).

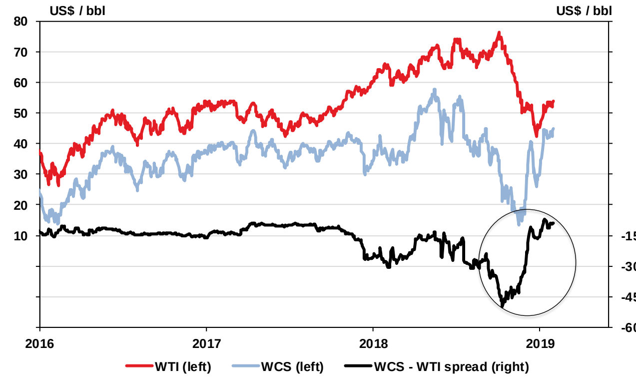
Regarding Sino-American trade tensions, as U.S. Commerce Secretary Wilbur Ross said on January 24, "we're miles and miles from getting a resolution and frankly that shouldn't be too surprising — trade is complicated and there are lots and lots of issues," later adding that "I think there's a fair chance we do get to a deal." In other words, the situation is far from crystal clear. However, what has become apparent recently is that Trump's capacity to act tough has diminished significantly: the tax cut boost is now history, his seemingly favourite *Key Performance*

14 **Leadership change in the making?**



CIO Office (data via Refinitiv)

15 **Alberta's cuts doing their job**



CIO Office (data via Refinitiv)

Indicator (the stock market) is lagging international peers, many U.S. corporations are complaining over tariff impact on their bottom line, and he is grappling with a Democratic House hungry for a win.

That being said, it would be entirely fitting with his character to move forward with his much-threatened tariff increases after March 1, regardless of the consequences. But, perhaps he should be reminded that Chinese policymakers have the enviable advantage of having the flexibility to quickly adjust monetary and fiscal policy as needed.

In light of the foregoing, we reshuffled our geographical mix, reducing our allocation in U.S. equities to the benefit of both emerging markets and Canadian equities. The end-result is an overall cheaper portfolio on a price/earnings basis with reduced expected volatility, and that is better aligned with the weakening of the U.S. dollar that we expect in the upcoming quarters.

Commodities: Spotlight on Venezuela and WCS

Venezuela's rapidly deteriorating political situation finally boiled over into its energy sector, with the U.S. imposing sanctions on the state-owned company *Petroleos de Venezuela* (PDVSA). Yet, anyone who hoped this would result in greater demand for Canadian products or materially higher energy prices down the road is bound to be disappointed:

1- The Western Canada Select (WCS) to West Texas Intermediate (WTI) spread is already back to pre-2018 levels (**Chart 15**), thanks to the Alberta government's decision to curtail overproduction by 325,000 barrels per day (bpd) from the province. Consequently, the spread is not wide enough to incentivize new exporting methods which would resolve the current export- capacity constraints.

The recent decision by Premier Notley to reduce the initial planned cuts by 75,000 bpd for February and March highlights another problem: there is still a huge capacity for ramp-up in activity should the energy levels become attractive enough, which limits upside potential for prices.

2- U.S. refineries are entering maintenance season, which usually translates to lower demand for crude oil products until Spring, mitigating the effect of the sanctions.

3- In a scenario where supply disruptions become material enough to warrant significant price increases in the U.S., the government still has the option to initiate a *Strategic Petroleum Reserve* (SPR) release which could ease those pressures until the issues are resolved.

All in all, U.S. sanctions are more likely to generate a change in trade flows than an outright loss of production affecting the global supply-and-demand picture. For example, China and India could buy PDVSA's production at a severely discounted price while the U.S. turns to Mexico to fill the gap.

As a result, we expect the WCS spread to remain stable for now, allowing Canadian oil prices to slowly increase along with their international peers by the end of the year.

CIO Office

CIO-Office@bnc.ca

Martin Lefebvre
CIO and Strategist
martin.lefebvre@nbc.ca

Simon-Carl Dunberry
Chief Analyst
simon-carl.dunberry@nbc.ca

Louis Lajoie
Principal Analyst
louis.lajoie@nbc.ca

Nicolas Charlton
Analyst
nicolas.charlton@nbc.ca

General

The present document was prepared by National Bank Investments Inc. (NBI), a wholly owned subsidiary of National Bank of Canada. National Bank of Canada is a public company listed on the Toronto Stock Exchange (NA: TSX).

The information and the data supplied in the present document, including those supplied by third parties, are considered accurate at the time of their printing and were obtained from sources which we considered reliable. We reserve the right to modify them without advance notice. This information and data are supplied as informative content only. No representation or guarantee, explicit or implicit, is made as for the exactness, the quality and the complete character of this information and these data. The opinions expressed are not to be construed as solicitation or offer to buy or sell shares mentioned herein and should not be considered as recommendations. The opinions are not intended as investment advice nor are they provided to promote any particular investments and should in no way form the basis for your investment decisions. National Bank Investments Inc. has taken the necessary measures to ensure the quality and accuracy of the information contained herein at the time of publication. It does not, however, guarantee that the information is accurate or complete, and this communication creates no legal or contractual obligation on the part of National Bank Investments Inc.

NBI or its affiliates often act as financial advisor, agent or underwriter for certain issuers mentioned herein and may receive remuneration for its services. As well NBI and its affiliates and/or their officers, directors, representatives, associates, may have a position in the securities mentioned herein and may make purchases and/or sales of these securities from time to time in the open market or otherwise.

This document is for distribution only under such circumstances in Canada and to residents of Canada as may be permitted by applicable law. This document is not directed at you if NBI or any affiliate distributing this document is prohibited or restricted by any legislation or regulation in any jurisdiction from making it available to you. You should satisfy yourself before reading it that NBI is permitted to provide this document to you under relevant legislation and regulations.

Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments (the “Funds”). Please read the prospectus of the Funds before investing. The Funds’ securities are not insured by the Canada Deposit Insurance Corporation or by any other government deposit insurer. The Funds are not guaranteed, their values change frequently and past performance may not be repeated.