NATIONAL BANK

ASSET ALLOCATION STRATEGY

January 7, 2019

From a windy 2018 to a stormy 2019?

Highlights

- After spending 2017 sheltered from volatility – thanks to low inflation pressures and strong synchronized growth – global markets ventured into the outdoors in 2018, resulting in a disappointing year for most investors, with nearly all assets but cash and government bonds offering losses.
- At this point, the key question is whether 2018 headwinds will evolve into a real economic storm, or will they end up whisking away the many clouds that had gathered toward the end of the year. As we move into 2019, we review the current state of (1) global economic growth, (2) monetary policies, (3) asset valuations, and (4) investors sentiment.
- Global growth should slow in 2019, but not to the point of ending the ongoing economic expansion. U.S. labour market conditions and leading economic indicators still show no symptoms indicative of an upcoming recession.
- Both U.S. and Canadian monetary policies should continue to tighten toward a neutral level in 2019, but at a much slower pace. This context is likely to lead to modestly higher 10-year government bond yields over the course of the year. The removal of accommodative policies undoubtedly makes life harder for equities, which should therefore continue to exhibit a fair degree of volatility.
- The turbulence of 2018 moved the valuation needle across all asset classes, but especially for global equities and safer government bonds, while corporate credit spreads continue to display some valuation downside risk. We believe this argues in favour of an equity overweight. As for fixed-income assets, investors should consider going up in quality by reducing their credit-risk exposure and opt for a short-duration positioning that is less aggressive.
- Investors' sentiment is extremely pessimistic, which bodes well for the next few months. However, the seemingly chaotic geopolitical backdrop is likely to continue in 2019, which could potentially affect investors' risk appetite for a prolonged period and ultimately business investment.
- So, will 2019 be a stormy year? Yes, in the sense that being late cycle implies continuing high volatility, but the current state of economic and monetary fundamentals suggest equities should nevertheless be able to weather the storm. This view is also backed by the combination of depressed stock valuations and heightened fear, which increases the chances of a bounce in risk assets over the short-term.
- Even so, prudence should be the motto this year. The 2019 investment backdrop could hardly be more challenging, with global growth (and especially China) losing steam, the Federal reserve increasingly prone to policy mistakes, and a U.S. President seemingly willing to put the stability of the world economy at stake in his quest for re-election. These are the three key risks for this 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

2018 Market Review

Fixed Income

- The Fed maintained its path towards normalization this year, applying a total of four rate hikes. While short-term rates continued to swell, medium- and long-term rates were slower to adjust with the 10-year rate climbing only 28 bps.
- A similar flattening of the yield curve occurred in Canada as Bank of Canada Governor Stephen Poloz announced three rate hikes, bringing the 3-month rate up 75 bps to 1.75%. Growing concerns that the economy may have reached its peak in the cycle led 10-year rates to fall 8 bps over the same period.

Canadian Equities

- This was the worst year for Canadian equities since the 2008 financial crisis, as the S&P/TSX composite fell 8.9%. It must be noted, however, that 2011 and 2015 both saw similar drops of 8.65% and 8.32% respectively – indicating that this kind of correction is not unheard of.
- A majority (8/11) of sectors saw negative returns with Energy and Consumer Discretionary leading the pack, losing 18.3% and 16.0% respectively.

U.S. Equities

- For the first time in a decade, the S&P 500 finished the year in the red after falling 4.4%. Despite a strong bull run from April to October, market sentiment soured in the final months of the year, paving the way for its worst December run (-10.24%) since 1931.
- A silver lining for Canadian investors exposed to the U.S. market: CAD-adjusted S&P 500 returns were positive at 4.23%.

Commodities

- Oil prices fell 25.3%, with the WTI closing the year at 45.15 US$ per barrel. Increased supply from U.S. shale producers, a decline in emerging market growth prospects, and OPEC's inability to coordinate large scale supply cuts until very late in the year all played their part in sending oil prices at their lowest since September 2017.
- Gold made a strong comeback in Q4, rallying 7.5% over the period and acting as a safe-haven for investors seeking shelter from the equity market sell-off.

Foreign Exchange

- The Loonie depreciated against the U.S. dollar losing 8.4% over the year closing at slightly over 0.73 US$. Trade tensions relating to NAFTA, an increasing rates differential with the U.S., and Alberta's inability to get its oil to market were likely suspects for the Loonie's poor performance.
- The U.S. dollar index fared much better, gaining 4.4%. On the other hand, amid ever-growing uncertainty related to Brexit and the possibility of a decelerating economy, the Euro and the British pound finished the year down 4.8% and 5.4% against the U.S. dollar.

Table 2 Market Returns

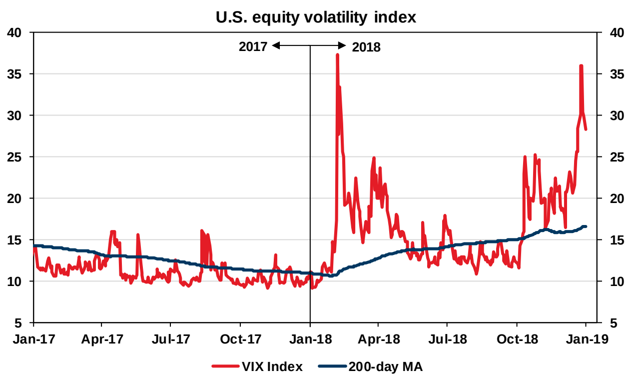
Asset classes	December	Q4	2018
Cash (3-month T-bills)	0.2%	0.5%	1.4%
Bonds (FTSE/TMX Ovr. Univ.)	**1.4%**	**1.8%**	**1.4%**
FTSE/TMX Short term	0.9%	1.4%	1.9%
FTSE/TMX Mid term	1.6%	2.4%	1.9%
FTSE/TMX Long term	1.9%	1.9%	0.3%
FTSE/TMX Government	1.5%	2.1%	1.5%
Federal	1.7%	2.5%	2.4%
Provincial	1.3%	1.7%	0.7%
Municipal	1.0%	1.6%	0.9%
FTSE/TMX Corporate	1.1%	0.9%	1.1%
AA+	0.9%	1.3%	1.8%
A	1.2%	1.0%	0.5%
BBB	1.0%	0.4%	1.0%
BoAML High-Yield (USD)	-2.2%	-4.6%	-2.3%
Preferred Shares	-1.6%	-10.0%	-7.9%
Canadian Equities (S&P/TSX)	**-5.4%**	**-10.1%**	**-8.9%**
Energy	-6.8%	-17.3%	-18.3%
Industrials	-9.3%	-13.4%	-2.4%
Financials	-7.1%	-11.3%	-9.3%
Materials	5.7%	0.9%	-9.3%
Utilities	-3.1%	-1.3%	-8.9%
Cons. Disc	-8.5%	-11.9%	-16.0%
Cons. Staples	-1.0%	5.7%	2.0%
Healthcare	-16.6%	-35.3%	-15.9%
IT	-5.2%	-10.3%	13.0%
Telecom	-2.7%	2.0%	-0.8%
REITs	-4.4%	-6.7%	2.0%
S&P/TSX Small Cap	-3.5%	-14.4%	-18.2%
US Equities (S&P500 USD)	**-9.0%**	**-13.5%**	**-4.4%**
Energy	-12.7%	-23.8%	-18.1%
Industrials	-10.7%	-17.3%	-13.3%
Financials	-11.3%	-13.1%	-13.0%
Materials	-6.9%	-12.3%	-14.7%
Utilities	-4.0%	1.4%	4.1%
Cons. Disc	-8.4%	-16.4%	0.8%
Cons. Staples	-9.1%	-5.2%	-8.4%
Healthcare	-8.6%	-8.7%	6.5%
IT	-8.5%	-17.3%	-0.3%
Telecom	-7.3%	-13.2%	-12.5%
REITs	-7.4%	-3.8%	-2.2%
Russell 2000 (USD)	-12.0%	-20.5%	-12.2%
World eq. (MSCI ACWI)	**-7.0%**	**-12.7%**	**-8.9%**
MSCI EAFE (USD)	-4.8%	-12.5%	-13.4%
MSCI EM (USD)	-2.6%	-7.4%	-14.2%
Commodities (CRB index)	**-1.7%**	**-1.4%**	**-5.4%**
WTI Oil (US$/barrel)	-11.1%	-38.3%	-25.3%
Gold (US$/ounce)	5.1%	7.5%	-1.7%
Copper (US$/tonne)	-4.5%	-5.0%	-17.5%
Forex (DXY - US Dollar index)	**-1.1%**	**1.1%**	**4.4%**
USD per EUR	1.0%	-1.6%	-4.8%
CAD per USD	2.6%	5.7%	8.4%

Source: Datastream 12/31/2018

The wind picked up in 2018 …

After spending 2017 sheltered from volatility – thanks to low inflation pressures and strong synchronized growth – global markets ventured into the outdoors in 2018, starting full of confidence with the S&P 500 delivering its biggest January return in 29 years. At those speeds, it wouldn't take much more than a small gust of wind for risk assets to lose balance. The combination of surprisingly high U.S. wage growth and the knock-on effects of overcrowded inverse VIX positions provided the ideal setting for a sharp return to volatility as early as February (**Chart 1**).

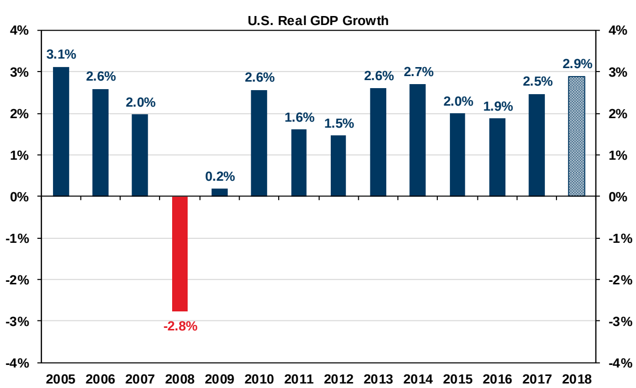
1 Sharp resurgence of volatility in 2018



Source: Datastream

U.S. equities got back on their feet without too much trouble thereafter, propelled by the largest tax cuts in over 30 years and, consequently, a domestic economy on track to post its strongest GDP growth since 2005 (**Chart 2**).

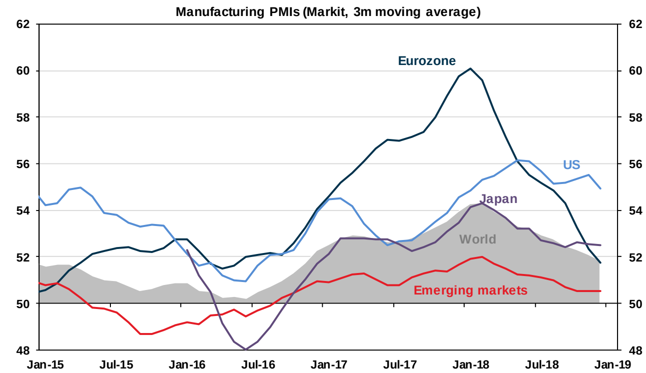
2 Strongest GDP growth since 2005 in the U.S. …



Source: Datastream, 2018 estimate = Consensus forecast from Consensus Economics inc.

The same could not be said for other regions, harmed by Washington's aggressive trade rhetoric staggered throughout the year and the subsequent deceleration in their economies (**Chart 3**).

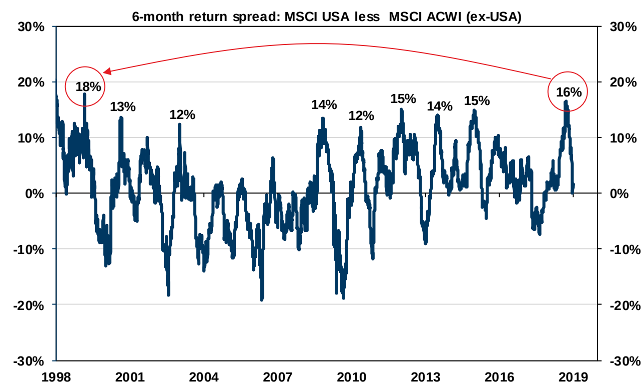
3 … while the rest of the world lost pace …



Source: Datastream

It is against this backdrop that we saw the six-month return spread between U.S. and non-U.S. equities peak at 16% in September 2018, the largest gap since 1999 (**Chart 4**).

4 … leading to the largest return divergence in 19 years

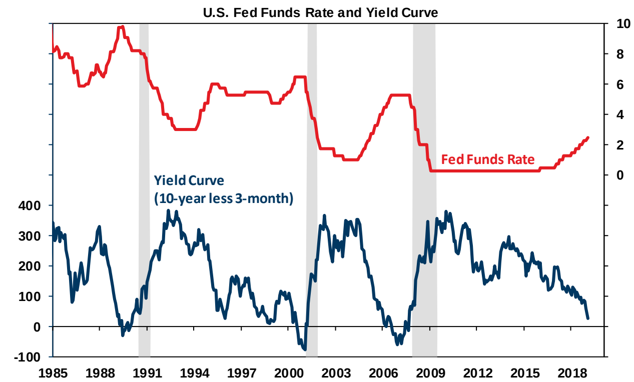


Source: Datastream

However, only in the last quarter did the wind gusts really start to intensify, as the yield curve neared inversion and the steady pace of the Federal Reserve's interest rate hikes fuel debate on the life expectancy of an economic expansion already nearly 10 years old (**Chart 5**, next page).

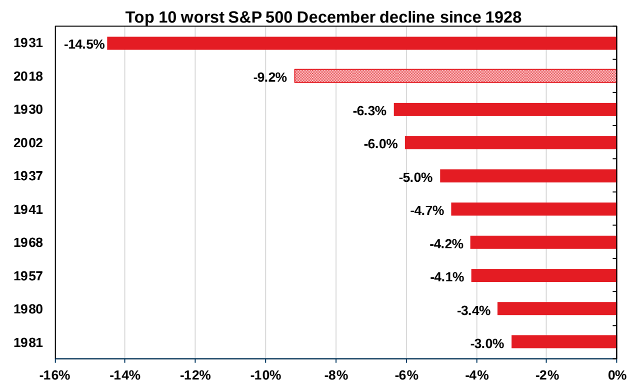
Topping things off, President Trump offered – just in time for the holidays – a partial shutdown of the U.S. government, in addition to reportedly contemplating the possibility (and legality) of firing Federal Reserve Chairman Jerome Powell. The market reaction was particularly brutal and arguably exaggerated, with the S&P 500's December decline ranking as the second worst since 1928. These types of routs are usually synchronous with periods marked by either a major depression, a world war, or a recession (**Chart 6**, next page).

5 Rate hikes and a flattening yield curve… a stressful mix



Source: Datastream

6 S&P 500 December decline ranks 2nd worst since 1928!?



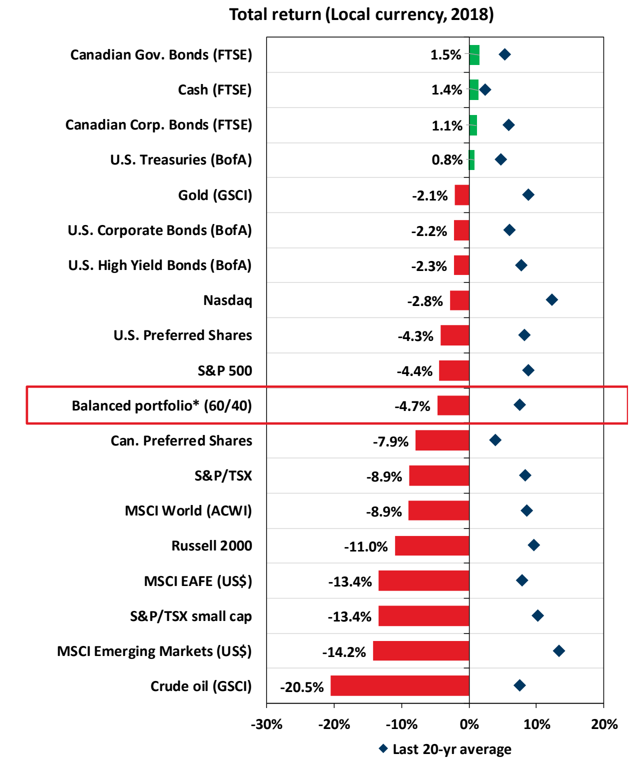
Source: Datastream, Bloomberg

So where does that leave us after 12 months? A disappointing year for most investors, with nearly all assets but cash and government bonds offering losses in 2018. For a plain vanilla passive portfolio (60% equities, 40% bonds), the end result is a poor, yet not catastrophic 4.7% loss (**Chart 7**).

However, it should be noted that this negative showing shrinks to just 1.5% when you convert foreign equity indices to Canadian dollars, with 2018 being a prime example of the diversifying benefits we get from having a cyclical home currency and investing abroad. For instance, the 5.7% loss in value for the Loonie sends the S&P/TSX from second (in local currency) to last position (in Canadian dollars) against U.S., EAFE, and emerging market equities in 2018 (**Chart 8**).

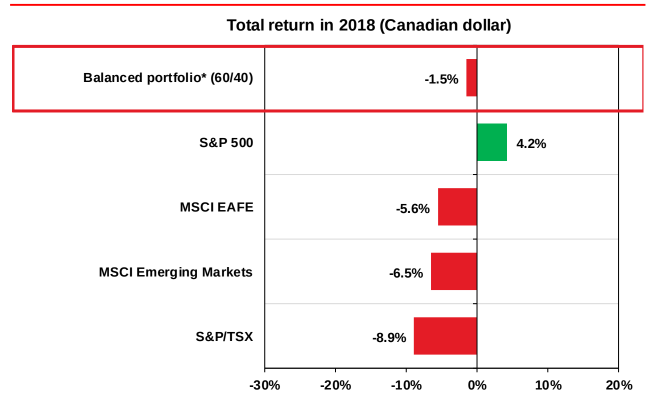
Diversification means there will almost always be something you dislike in your portfolio, but those with a heavy home bias will possibly find themselves with very little to like looking back on 2018.

7 A disappointing year, but not catastrophic



Source: Datastream.***40% Bonds** (95% FTSE TMX Bonds universe C$, 5% Cash C$), **60% Equities** (35% S&P 500 US$, 35% S&P/TSX C$, 20% MSCI EAFE US$, 10% MSCI EM US$)

8 …especially when translated into Canadian dollars



Source: Datastream

… is this a harbinger of a stormy 2019?

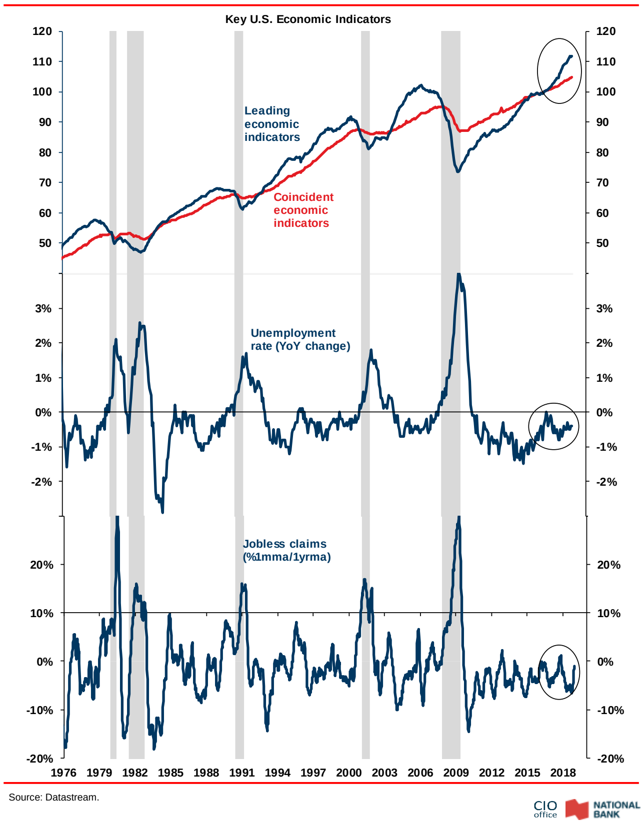
At this point, the key question is whether the 2018 headwinds will evolve into a real economic storm, or will they end up whisking away the many clouds that gathered toward the end of the year. To be sure, let us review the current state of (1) global economic growth, (2) monetary policies, (3) asset valuations, and (4) investors sentiment as we move into 2019.

1- Global economic growth

Global growth should slow in 2019, but not to the point of ending the ongoing economic expansion, as fundamentals supporting corporate profits remain in place.

To begin with, U.S. labour market conditions still show no symptoms indicative of an upcoming recession, as both weekly jobless claims and the unemployment rate continue to tick lower. Similarly, the Conference Board's leading Economic Indicators index (LEI) continues to distance itself from coincident indicators, suggesting further growth ahead (**Chart 9**).

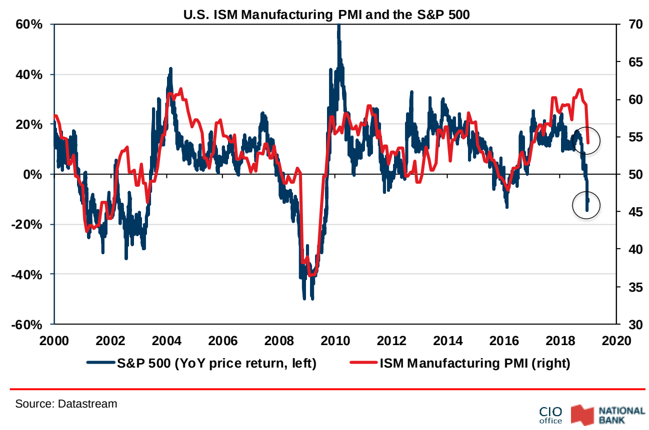
9 Labour market and LEI suggesting further growth ahead



Now, that doesn't mean that we should ignore the signals sent by the recent stock market retreat which, after all, is one of the 10 metrics included in the LEI. However, it wouldn't be the first time that equity overreacts to a deceleration in global growth, as appears to be the case. Indeed, the ISM Manufacturing PMI report, published January 3, did show marked moderation in the growth rate of American manufacturing companies, but remains way above the contraction (sub-50s) the S&P 500 downturn is implying (**Chart 10**).

Another concern for investors appears to be U.S. companies' capacity to keep growing their bottom line, after two outstanding years marked by a global synchronized upswing in economic activity (2017) and almost unprecedented tax cuts (2018). What's more, it is acknowledged that equity analysts'

10 Is the S&P 500 overreacting to growth deceleration?

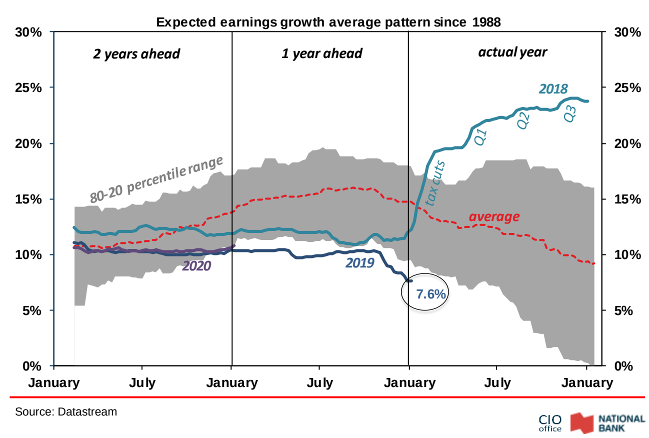


earnings forecasts tend to be overly optimistic, only to be revised lower just in time for earnings season. We, therefore, investigated how 2019 earnings' growth expectations compare relative to history, and have come to the following conclusions.

First, 2018 earnings growth was exceptional and not only because of tax cuts, as companies kept on raising the bar with each earnings' season.

Second, the 7.6% earnings growth that analysts expect in 2019 is, in fact, among the most pessimistic we've seen looking at data going back to 1988. Although, we would characterize it as rather realistic given the expected global slowdown (**Chart 11**).

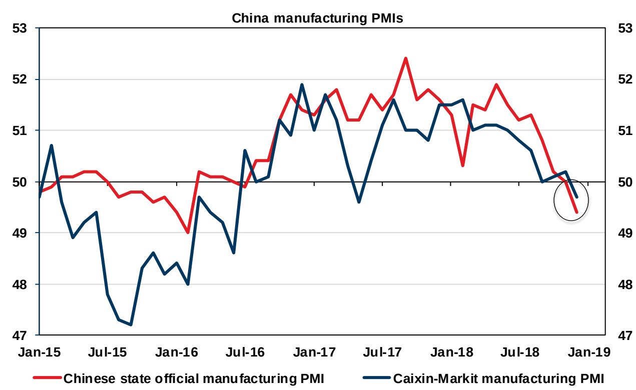
11 U.S. earnings forecasts for 2019 appear realistic …



In the near term, we will pay close attention to the Q4-2018 earnings season, as it should give more colour over what to expect from companies in 2019. Knowing that over half of the S&P 500 index constituents have corrected by 20% or more recently, one can expect corporate guidance to sound reassuring. However, Apple's decision to shave its revenue forecast on January 2 does not make for an auspicious start.

Moreover, that most of Apple's cuts in growth prospects were driven by weakness in the Chinese economy reflects the fact that we cannot assess global economic conditions without taking China into account nowadays. The challenges the country is facing are enormous and involve walking a tightrope between managing the structural slowdown in their economy and the battle against excessive debt – in addition to a trade war with the United States. This harsh context was echoed in January reports from China's manufacturing sector, with the state-official and private PMIs dipping in contraction territory for the first time in 29 months and 19 months, respectively (**Chart 12**).

12 … but watch for China



Source: Datastream

On the positive side, the Chinese leadership has clearly signalled its intention to take action. In addition to personal income tax cuts that take effect this month, policy makers promised further fiscal stimulus and increased funding for infrastructure at their annual Central Economic Work Conference that concluded on December 21. How this will materialize remains highly uncertain and is **one of our three key risks for 2019**. But, the information currently available leads us to conclude that China will keep a tight rein on its deceleration, thanks to fiscal and monetary easing.

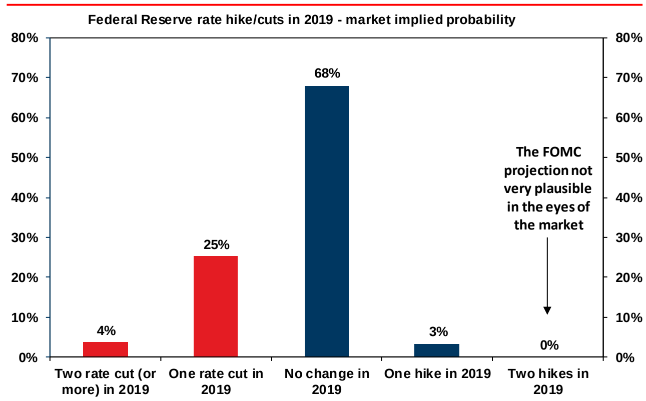
To sum things up, we still consider global economic conditions to be supportive of risk assets' outperformance, although rising geopolitical tensions in an aging business cycle render this outlook increasingly fragile. We will continue to closely monitor U.S. labour market indicators, global manufacturing PMIs, corporate earnings results and Chinese growth, watching for signs of mounting weakness.

2- Monetary policies

Both U.S. and Canadian monetary policies should continue to tighten toward a neutral level in 2019, but at a much slower pace. This context is likely to lead to modestly higher 10-year government bond yields over the course of the year. Still, risks are to the downside as central banks face a combination of a yield curve that is nearing inversion and nervous investors, not to mention the fact that the U.S. President himself seems to have found a new scapegoat in Jerome Powell.

The Federal Reserve attracted the wrath of equity investors in December, seemingly upset by Powell's nonchalance about the Fed's balance-sheet reduction program and the FOMC's decision to only lower their 2019 rate hike projections (i.e. median dots) from three to two. The Fed Governor then backtracked at an economic conference on January 4th, specifying that he "wouldn't hesitate" in pausing its balance sheet shrinkage if needed and that he was "listening carefully" to markets. There is indeed a certain distance between the Fed and what is currently priced by markets: a 68% chance of zero rate hikes this year, and 29% of at least one rate cut. (**Chart 13**).

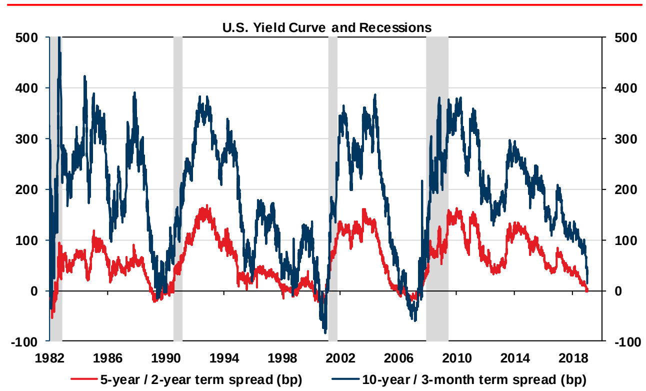
13 The Fed says two hikes… the market says zero (or less) …



Source: Bloomberg as of January 7, 2019

True, the fact that the yield curve (10-year Treasuries less 3-month T-Bills) is nearing inversion – a near perfect predictor of recessions historically – arguably calls for a pause by the Fed. What's more, the recent inversion of the yield spread between 5-year and 2-year Treasury bonds certainly did not go unnoticed (**Chart 14**).

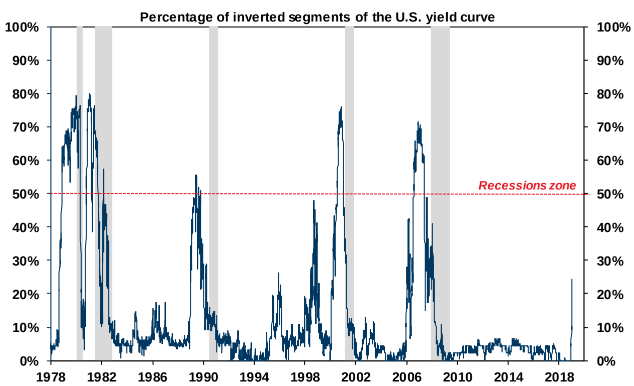
14 … as the yield curve is nearing danger zone



Source: Datastream

However, we think that investors shouldn't put too much emphasis on a single term spread, as they are much more prone to false signals. For 2019, our focus will rather be on the breadth of the yield curve inversion, which measures the percentage of all possible term spreads that are inverted, looking at maturities ranging from the overnight rate all the way up to 30-year treasury bonds. It is currently at its highest in 10 years (22%), which calls for extra caution on the part of central bankers. But there is still some way to go before reaching the 50% threshold that has accurately signalled the last five recessions (**Chart 15**).

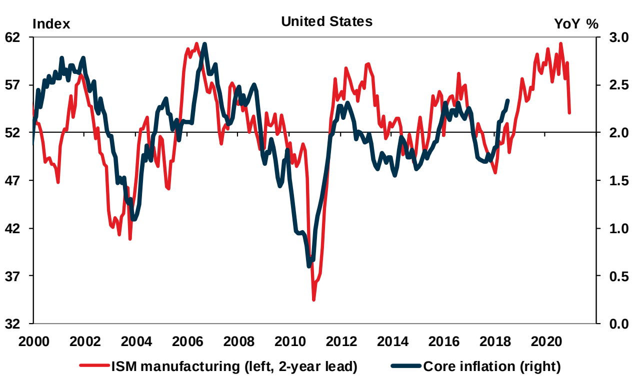
15 Watch for the breadth of the yield curve inversion



Source: Datastream. Maturities included = Effetive fed funds rate, 3m, 6m, 1y, 2y, 3y, 5y, 7y, 10y, 30y

Under these circumstances, if global growth is to extend into 2019 as we expect while inflation keeps accelerating slightly as suggested by the strong level of economic activity of recent years (**Chart 16**), it is reasonable to assume that the Federal Reserve will stick to its plan to remove monetary policy accommodation.

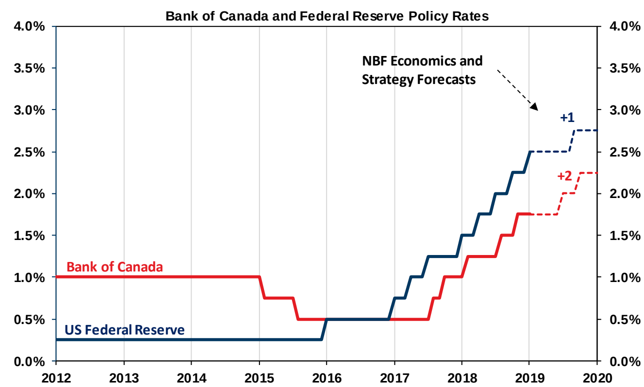
16 Inflation should keep accelerating slightly in 2019 ...



Source: Datastream

According to NBF Economics & Strategy projections set to come out later this week, this implies just one rate hikes south of the border in 2019. As for the Bank of Canada, recent crude oil woes, in addition to Statistics Canada's downward revisions to GDP growth back to 2015, did nothing to simplify their already complex mandate. We should have a little more clarity over Governor Poloz intentions on January 9, as the BoC will publish its quarterly Monetary Policy Report. But for now, the Central Bank is expected to stay put in the first half of 2019, and to play catch-up with the Fed via two rate hikes thereafter (**Chart 17**).

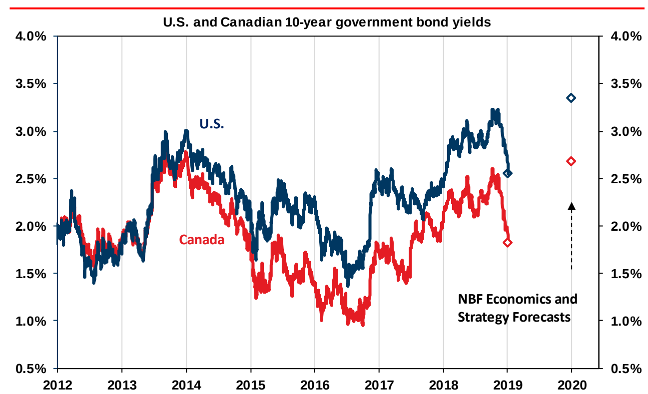
17 ... leading central banks to pursue policy normalization



Source: Datastream, NBF Economics and Strategy

On their end, 10-year maturities rallied quite sharply in the latter part of 2018, benefitting from strong investor appetite for safe-haven assets. Going forward, economic and monetary conditions should push government bond yields modestly higher, assuming this risk aversion subsides. Forecasts from NBF Economics & Strategy put U.S. and Canadian 10-year Treasury yields at 3.34% and 2.68%, respectively, by the end of 2019 (**Chart 18**).

18 ... and 10-year yields to resume their upward trend



Source: Datastream, NBF Economics and Strategy

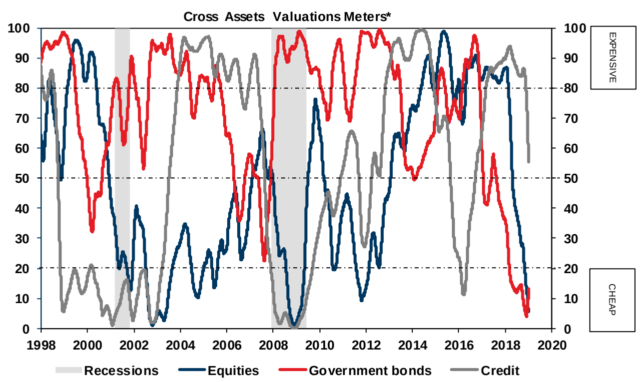
In short, the key takeaway is that the accommodative monetary policy tailwind that risk assets enjoyed over the last decade is well on its way to vanishing, at least in North America. This undoubtedly makes life harder for equities, which should therefore continue to exhibit a fair degree of volatility. Still, it should not prevent stocks from generating positive returns, as central banks are likely to continue to exercise caution and we don't expect policy rates to turn restrictive any time soon. To be certain, the U.S. Treasury yield curve and Federal Reserve communications will require extra attention this year, considering the margin of error of a policy mistake has narrowed considerably. This is indeed our **second key risk for 2019**.

3- Valuations

The turbulence of 2018 has moved the valuation needle across all asset classes, especially so for global equities and safer government bonds, while corporate credit spreads continue to display some valuation downside risk.

At least, that is what shows our cross-asset valuation meters, which measure the 5-year percentile rank of global equity PE ratios (blue line), North American 10-year treasury yields (red line), and corporate credit spreads (grey line). This is the first time that both risky stocks and safer treasuries find themselves together in "cheap" territory, a fact that in our view should not be ignored heading into 2019 (**Chart 19**).

19 2018 turmoil gave rise to attractive valuations …

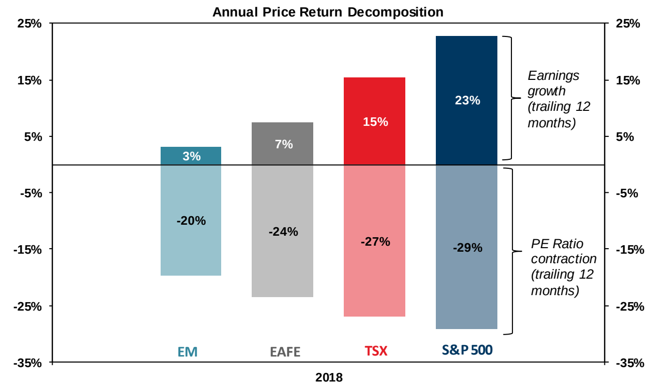


Source: Datastream, NBI CIO Office. 60-day moving average of 5-year rolling percentile rank. **Credit** = Canadian IG, U.S. IG and U.S. HY spreads. **Government bonds** = Canadian and U.S. 10-year trasury yield. **Equities** = MSCI EM. MSCI EAFE, S&P/TSX and S&P 500 fwd PE ratio

Zooming into global equities, it must be emphasized that ratio contraction is the main culprit behind the annual performance of the main four indices – their worst since the great financial crisis – as trailing earnings continued to improve in 2018 (**Chart 20**).

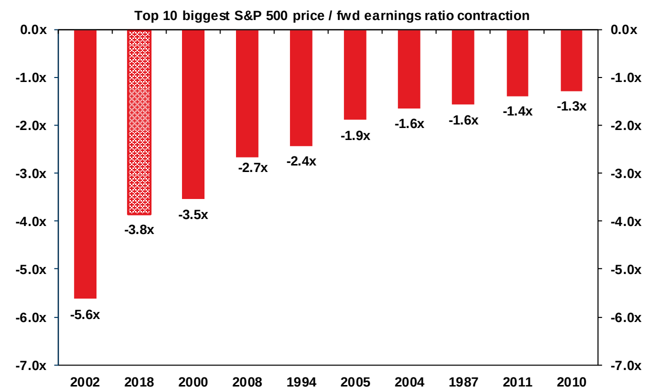
To put things into perspective, the S&P 500's decline in its forward price/earnings ratio is the second worst since 1986 (**Chart 21**). That means that, unless corporate earnings disappoint substantially, stocks should generate decent returns in 2019 as they present a significantly better risk-reward profile. Nevertheless, if the global economic expansion was to stop abruptly, one should expect further ratio contraction, especially in the U.S., where multiples started from their upper reaches and are now only slightly below their median of the last 30 years (**Chart 22**).

20 … with equities decline attributable to PE contraction …



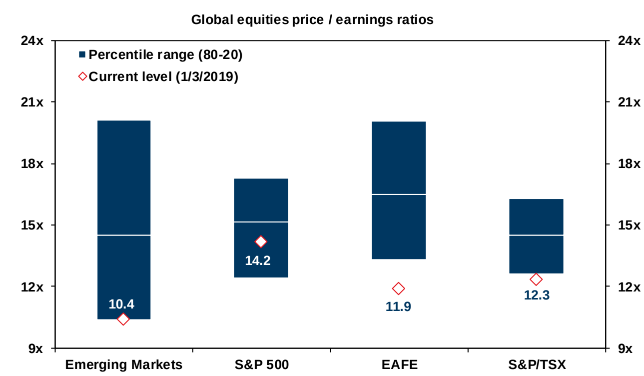
Source: Datastream

21 … of a magnitude rarely observed



Source: Datastream

22 Where are multiples with respect to their last 30 years?



Source: Datastream

To put it simply, we believe the current valuation backdrop argues in favour of an equity overweight. As for fixed-income assets, investors should start to consider going up in quality by reducing their credit risk exposure and opt for short duration positioning that is less aggressive. That way, you can benefit from both the opportunity presented by the 2018 equity market re-rating and rising treasury yields, all the while better gearing portfolios in tandem with the increasingly fragile economic, monetary, and geopolitical environments.

4- Sentiment

To say that investor sentiment is pessimistic is an understatement at this point, with last December being a prime example where fear breeds selling and selling breeds more fear. However, as history has shown us, investors should instead welcome these episodes of heightened fear as buying opportunities, and dread excesses of enthusiasm.

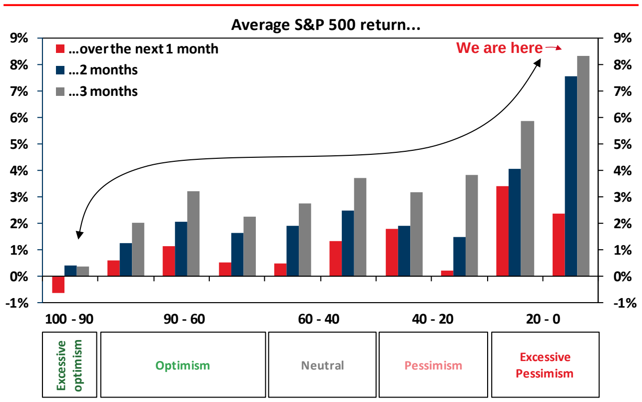
This is best captured by our own *Market Sentiment Indicator*[1] which fell in *extreme pessimism* territory on December 7 and has continued to struggle since (**Chart 23**).

23 Investors sentiment is excessively pessimistic…

Source: Datastream, Bloomberg, NBI CIO Office as of January 3rd, 2018.

Still, as we've advanced earlier, the good news is that it's in following these levels of pessimism that equities have historically performed best, posting an average of 7.6% and 8.3% over the next two to three months, respectively (**Chart 24**).

24 … something investors should rather welcome



Source: Datastream, Bloomberg, NBI CIO Office. Since January 1st 2010.

Whether the next few weeks will follow the average historical pattern remains to be seen, as this indicator must always be taken in parallel with its economic, monetary, valuation and geopolitical context. However, we can argue that it marks a point in favour of overweighting equities.

Speaking of geopolitics, it can be assumed that the seemingly chaotic backdrop is likely to continue in 2019 – if not worsen – with anything that surrounds the White House being our **third key risk for this year**. High conviction forecasting on this subject must be avoided, in our view. However, we know that the Robert Mueller probe on potential conspiracy with Russia during the 2016 Presidential election is expected to conclude in early 2019. It is possible that this leads to an impeachment process enacted by the Democratic House (with a simple majority needed), although it would almost certainly be halted in the Senate (with a two-thirds majority needed to proceed).

As for the ongoing trade war between the U.S. and China, only God knows what's in President Trump's game plan, assuming one even exists. However, it does seem overly optimistic to us to believe that the 90-day ceasefire will be long enough for China to adequately address the many sources of friction surrounding its arguably unfair trade practices that have elevated the once-poor nation to superpower status in just a few decades.

Yet, before seeking refuge based solely on this premise, we must not forget that overreacting to geopolitical events constitutes one of the most frequent and costly mistakes when it comes to investing, especially in the long run. We should always ask ourselves to what extent an event affects companies' ability to run their businesses and generate profits. More often than not, the answer is "very little," and is certainly not proportional to the media attention it receives. That's why we covered geopolitics in the sentiment section, the main risk being that it affects investors' risk appetite for a prolonged period and may ultimately be reflected in business investment.

So, what's the bottom line?

Back to our very first question: will 2019 be a stormy year? Yes, in the sense that being late cycle implies continuing high volatility, but the current state of economic and monetary fundamentals suggest equities should nevertheless be able to weather the storm. This view is also backed by the combination of depressed stock valuations and heightened fear, which increases the chances of a bounce in risk assets over the short-term.

For us to turn outright defensive, we will need signs of an upcoming recession from the U.S. labour market and the breadth of the yield curve inversion, extreme valuations, or

[1] This indicator will be detailed in a separate document and added to our weekly publications early in 2019

investor euphoria. As we've detailed earlier, none of these conditions have yet been reached.

Even so, prudence should be the motto this year. The 2019 investment backdrop could hardly be more challenging, with global growth (and especially China) losing steam, the Federal reserve increasingly prone to policy mistakes, and a U.S. President seemingly willing to put at stake the stability of the world economy in his quest for re-election. These are the three key risks for this year.

Tactical positioning starting in 2019

- We keep our overweight equities over bonds unchanged.

- For fixed income, expect us to bring back our federal bonds recommendation from underweight to neutral, and move high yield from neutral to underweight once investor sentiment subsides and asset prices move from their extreme levels.

- For equities, we keep our geographical allocation unchanged for now, but will likely make some changes in the coming weeks as the dust settles and the earnings season kicks in.

- For crude oil, we think demand concerns are overblown and we expect a rebound in 2019. Still, should demand surprise us on the downside or shale oil production ramp up faster than expected, further cuts by OPEC+Russia would be needed to support prices.

- For the Canadian dollar, we continue to expect some appreciation over the coming months as it should benefit from an overall softer USD, better WCS-WTI spreads, and rebounding oil prices.

Martin Lefebvre
CIO and Strategist

Simon-Carl Dunberry
Chief Analyst

Louis Lajoie
Senior Analyst

Nicolas Charlton
Analyst