Easy Does It

Highlights

- The tide turned in favour of markets in June, with the Federal Reserve formally opening the door to potential monetary easing. This month, we briefly revisit the core of the U.S. Central Bank's job: ensuring maximum employment and price stability.
- There is no doubt that May's weak employment report has contributed to markets' expectations for rate cuts. But, a little hindsight makes it difficult to conclude that the U.S. labour market is anything other than in good shape. Case in point, the Central Bank has actually lowered its unemployment rate projections for 2019 and 2020.
- On the other hand, the persistent lack of inflationary pressure does somewhat support the case for an easing of monetary policy, with Core PCE having fallen back down more recently along with 10-year break-evens, inclining the Fed to lower its core inflation projections for this year and next.
- That said, it is mainly the risk management dimension of the Federal Reserve mandate that motivates the amplitude of rate cuts currently priced-in by markets and suggested by a growing list of FOMC participants, best summarized by Fed Chair Jerome Powell's use of the proverb "an ounce of prevention is worth more than a pound of cure."
- Will the upcoming FOMC meetings materialize in the first rate cut of this business cycle? The answer lies in how Sino-American negotiations and economic data evolve, but it would certainly be the first time in the last 25 years that Fed fund futures anticipate rate cuts of this magnitude without any occurring in the following months.
- With no exuberance *à la* early 2000s, no significant economic imbalances the likes of those years preceding the great financial crisis, and a still-robust economic backdrop, we view the growing possibility of an insurance-like rate cut as reinforcing our expectations for equities to do well over the next twelve months and not as a bad omen. However, we remain cautious on a tactical basis and maintain our neutral positioning between stocks and bonds in view of the volatile context, and in compliance with the recommendation of our A3 Model. Easy does it.
- Geographically, we continue to believe that our asset mix in favour of both U.S. and Canadian equities is adequate, and this is what our Geographic Relative Momentum model continues to advocate.
- The Federal Reserve's dovish shift turned out to be the necessary boost for the Canadian dollar to finally get off the ground. Going forward, we still foresee slight upside potential for the Loonie. But, considering the propensity of our currency to move in tandem with risk assets and the non-negligible probability of negative surprises on the trade front, some caution is advised in the short-term.
- Gold prices surged all the way to a six-year high last month. In few words, a play on gold is roughly equivalent to being short the Dollar, long Treasuries and long on inflation: three positions that generally benefit from a dovish U.S. Federal Reserve. As such, for gold to climb much higher, we would need to see the Central Bank deliver more dovishness than markets currently expect, without a recession driving inflation to the ground and safe-haven flows spurring the greenback too much. Let's just say, this isn't our base-case scenario.

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			■		

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Current Allocation ■

Previous Allocation ▨

Market Review

Fixed Income

- > Market-implied odds of a rate cut in July have reached 100%, following a more dovish FOMC statement. With rates projected to fall lower and investor sentiment still delicate, all fixed-income assets continued to appreciate last month.
- > High Yield realized a marked outperformance in June relative to its peers, as a tightening spread against its risk-free counterpart helped the index gain 2.4%.

Canadian Equities

- > Canadian Equities' performance in the first half of the year (16.2%) were their highest since 2009.
- > Less volatile than its southern neighbour, the Canadian market's smaller dip in May was met with a comparatively weaker recovery in June.
- > At the head of the pack was the Materials sector (up 13%), its rise largely explained by gold's astonishingly strong rally over the period.
- > On the other end of the spectrum were Telecom, Consumer Staples, and Energy (down 1.2%, 1.7% and 1.7% respectively), the latter unable to appreciate along with rising oil prices.

U.S. Equities

- > U.S. Equities' performance in the first half of the year (18.5%) were their highest since 1998.
- > Nearly symmetrical to its May performance, June saw a rebound in American stock prices as the rising probability of future rate cuts from the Fed seemed to outweigh headwinds in the form of continued trade uncertainty.
- > Materials and Energy took the top two spots (11.7% and 9.3% respectively), with gold and the WTI's sharp rise likely contributing greatly to the moves.
- > Meanwhile, the more bond-like REITs and Utilities sector lagged, the former just making a positive return for the month (up only 1.8%).

Commodities

- > Gold made headlines last month, rising sharply amid continued investor uncertainty, falling real yields, and a weakening U.S. dollar. The move marked the lustrous metal's largest monthly increase in three years.
- > Oil also impressed, WTI rising yet again this month to finish the period at 58.2 $/bbl, bolstered in part by a faster-than-expected fall in U.S. domestic stockpiles and a flare up in tensions between the U.S. and Iran.

Foreign Exchange

- > The U.S. dollar index (DXY) reversed course in June, wiping out its year-to-date gains. This abrupt change in direction came about following the FOMC's meeting of June 19.
- > On the other hand, the Loonie rallied (up 3.1%), supported in part by rising oil prices and a tightening spread between U.S. and Canadian rates, to finish the month at $1.31 U.S., its strongest level in seven months.

Table 2 Market Total Returns

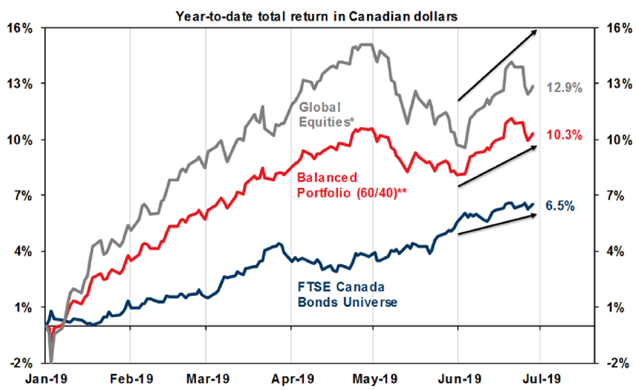
Asset classes	June	Q2	YTD
Cash (3-month T-bills)	0.1%	0.4%	0.8%
Bonds (FTSE/TMX Ovr. Univ.)	**0.9%**	**2.5%**	**6.5%**
FTSE/TMX Short term	0.1%	0.9%	2.7%
FTSE/TMX Mid term	0.5%	2.1%	5.9%
FTSE/TMX Long term	2.1%	4.8%	12.1%
FTSE/TMX Government	0.9%	2.4%	6.4%
Federal	0.3%	1.5%	4.0%
Provincial	1.4%	3.3%	8.8%
Municipal	1.2%	3.1%	8.1%
FTSE/TMX Corporate	1.1%	2.7%	6.8%
AA+	0.4%	1.5%	4.1%
A	1.5%	3.4%	8.3%
BBB	1.1%	2.9%	7.5%
BoAML High-Yield (USD)	2.4%	2.5%	10.1%
Preferred Shares	0.8%	-2.0%	-0.9%
Canadian Equities (S&P/TSX)	**2.5%**	**2.6%**	**16.2%**
Energy	-1.7%	-2.8%	12.3%
Industrials	1.7%	5.1%	21.1%
Financials	2.8%	3.5%	14.3%
Materials	13.0%	5.4%	14.4%
Utilities	1.3%	5.4%	22.4%
Cons. Disc	6.8%	4.6%	14.9%
Cons. Staples	-1.7%	1.7%	12.5%
Healthcare	3.1%	-9.3%	35.2%
IT	2.9%	14.3%	44.0%
Telecom	-1.2%	-0.2%	9.7%
REITs	0.9%	-1.4%	15.8%
S&P/TSX Small Cap	4.3%	-0.3%	10.4%
US Equities (S&P500 USD)	**7.0%**	**4.3%**	**18.5%**
Energy	9.3%	-2.8%	13.1%
Industrials	7.9%	3.6%	21.4%
Financials	6.7%	8.0%	17.2%
Materials	11.7%	6.3%	17.3%
Utilities	3.3%	3.5%	14.7%
Cons. Disc	7.8%	5.3%	21.8%
Cons. Staples	5.2%	3.7%	16.2%
Healthcare	6.6%	1.4%	8.1%
IT	9.1%	6.1%	27.1%
Telecom	4.3%	4.5%	19.1%
REITs	1.8%	2.5%	20.4%
Russell 2000 (USD)	6.9%	1.7%	16.2%
World eq. (MSCI ACWI)	**6.6%**	**3.8%**	**16.6%**
MSCI EAFE (USD)	6.0%	4.0%	14.5%
MSCI EM (USD)	6.3%	0.7%	10.8%
Commodities (CRB index)	**-1.9%**	**-4.2%**	**-0.3%**
WTI Oil (US$/barrel)	8.8%	-3.3%	28.9%
Gold (US$/ounce)	8.6%	9.0%	10.2%
Copper (US$/tonne)	3.0%	-7.8%	0.6%
Forex (DXY - US Dollar index)	**-1.7%**	**-1.2%**	**0.0%**
USD per EUR	2.2%	1.4%	-0.4%
CAD per USD	-3.1%	-1.9%	-4.0%

CIO Office (data via Refinitiv) 2019-06-28

Easy Does It

The tide turned in favour of markets in June, with the Federal Reserve formally opening the door to potential monetary easing, the U.S. Administration lifting the tariff threat on Mexico, and Sino-American trade tensions seemingly plateauing. As a result, global equities rebounded sharply from their May lows, while fixed-income assets pursued their steady march upward, bringing 2019 total returns for a balanced portfolio back into the double-digit range (**Chart 1**).

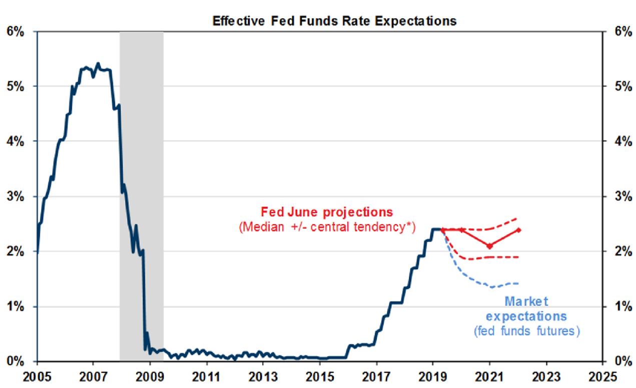
1 The tide turned in favour of markets in June…



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)

The much-awaited Federal Open Market Committee (FOMC) meeting of June 19 revealed updated rate projections closer to what markets had been calling for, with the median for next year showing one rate cut (vs. one rate hike back in March) and, perhaps more importantly, seven FOMC participants (of 17) embedding two rates cuts before year-end in their base-case scenario (**Chart 2**).

2 …with the Fed formally opening the *easy* door

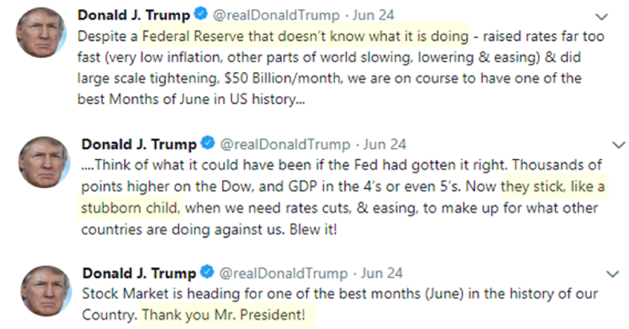


CIO Office (data via Refinitiv, U.S. Federal Reserve, Bloomberg). *The central tendency excludes the three highest and three lowest projections.

One might think that the Central Bank is simply succumbing to pressure from the U.S. President's repeated calls for rate cuts — a President who, by the way, continues to display his proverbial subtlety in criticizing the Fed while ensuring that all the credit for June's S&P 500 gains goes to him (**Chart 3**).

However, before drawing this conclusion, let us briefly revisit the core of the Federal Reserve's job to better understand its reasoning and recent actions. The Fed's mandate when conducting monetary policy is two-fold: (1) maximum employment and (2) price stability.

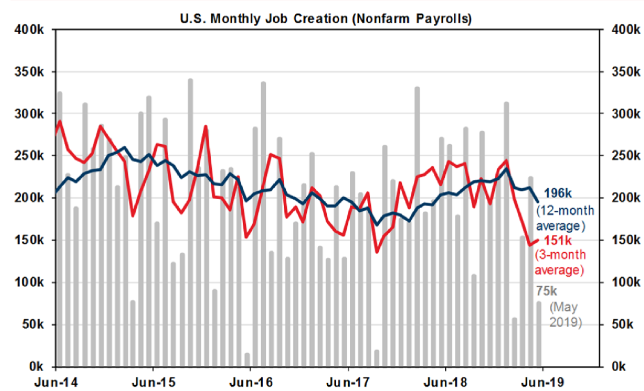
3 Thank you Mr. President?



CIO Office (Data via Twitter)

Regarding the first point, there is no doubt that May's weak employment report (+75k vs. 175k expected) has contributed to markets' expectations for rate cuts. However, a single month of weakness is far from abnormal and certainly not sufficient to reach any conclusions. With both the 3-month (+151k) and 12-month (+196k) averages running comfortably above the +110k level required to maintain the unemployment rate stable at its 50-year low of 3.6%, it is difficult to conclude the U.S. labour market is anything other than in good shape (**Chart 4**). Case in point, the Central Bank actually lowered its unemployment rate projections for 2019 (3.6% in June vs. 3.7% in March) and 2020 (3.7% vs. 3.8%).

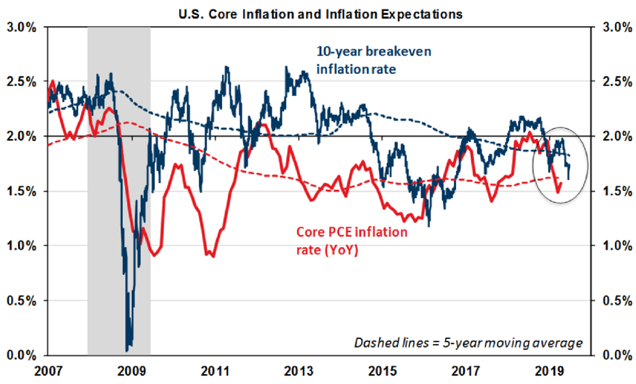
4 The U.S. labour market is in good shape…



CIO Office (data via Refinitiv).

What about the *price stability* portion of its mandate? The Fed manages this part by targeting a 2% annual inflation rate (its preferred measure being personal consumption expenditures, or PCE) and ensuring that expectations remain anchored near this level. Here's the thing: over the last decade, Core PCE inflation almost never reached this target, missing by an average of 42 bps, having stood in the 1.9%/2.1% range only 14 months out of 120 on a year-over-year basis. In addition, it has fallen back down more recently along with 10-year break-evens, a market-based measure of long-term inflation expectations (**Chart 5**). Under these circumstances, the Central Bank lowered its core inflation projections for 2019 (1.8% in June vs. 2.0% in March) and 2020 (1.9% vs. 2.0%).

5 ... but inflation has remained largely absent



CIO Office (data via Refinitiv).

In essence, the persistent lack of inflationary pressure does somewhat support the case for an easing in monetary policy stance by the Fed. However, it cannot on its own justify the amplitude of rate cuts currently priced-in by markets and suggested by a growing list of FOMC participants.

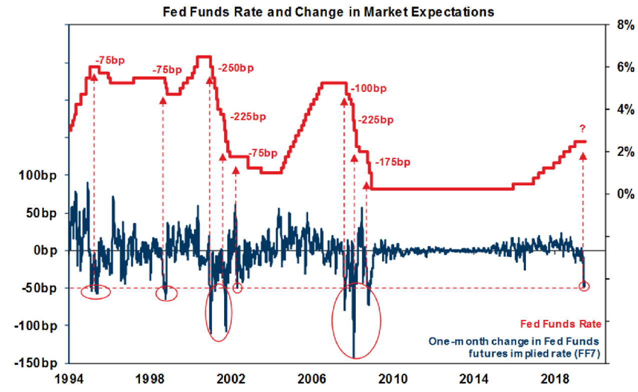
So, what else could support a rate cut by the end of the month? An increasingly prominent third component parallel to the Fed dual mandate of maximum employment and stable prices: risk management. Indeed, much like any portfolio manager, the Fed must account for the possibility that global uncertainties – especially with regard to the U.S./China tariff spat – end up materially affecting the economy, as best summarized by Fed Chairman Jerome Powell's use of the proverb "an ounce of prevention is worth more than a pound of cure" during his last press conference. This requires striking the right balance between communicating his willingness to act promptly, if need be, without overreacting to events that ultimately turn out to be short-lived. Not so easy.

Will the upcoming FOMC meetings materialize in the first rate cut of this business cycle? The answer lies in how Sino-American negotiations and economic data evolve. But, it would certainly be the first time in the last 25 years that Fed funds futures anticipate rate cuts of this magnitude without any occurring in the following months (**Chart 6**).

What if it does happen? While the last two rate-cutting cycles were not a good story for equities, a look further back in history paints a better picture (**Chart 7**).

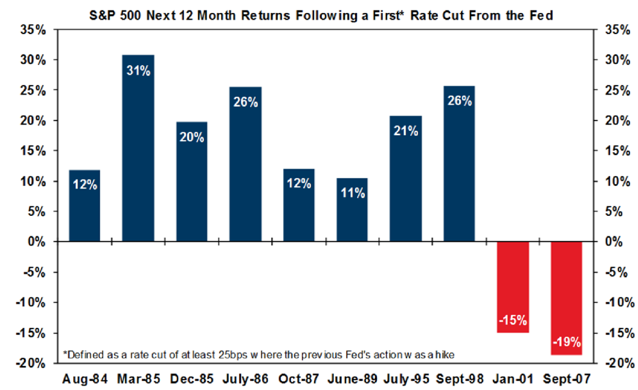
With no exuberance *à la* early 2000s, no significant economic imbalances the likes of those years preceding the great financial crisis, and a still-robust economic backdrop, we view the growing possibility of an *insurance-like* rate cut as reinforcing our expectations for equities to do well over the next twelve months and not as a bad omen. However, we remain cautious on a tactical basis and maintain our neutral positioning between stocks and bonds in view of the volatile

6 Markets are sending a clear cutting signal



CIO Office (data via Refinitiv, Bloomberg).

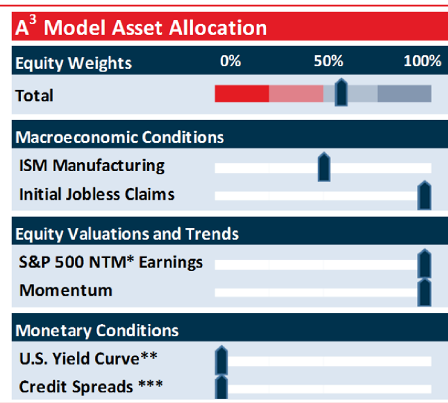
7 Hiking → Cutting ≠ Financial meltdown



CIO Office (data via Refinitiv).

context, and in compliance with the recommendation of our A^3 Model (**Chart 8**). Easy does it.

8 We remain cautious on a tactical basis

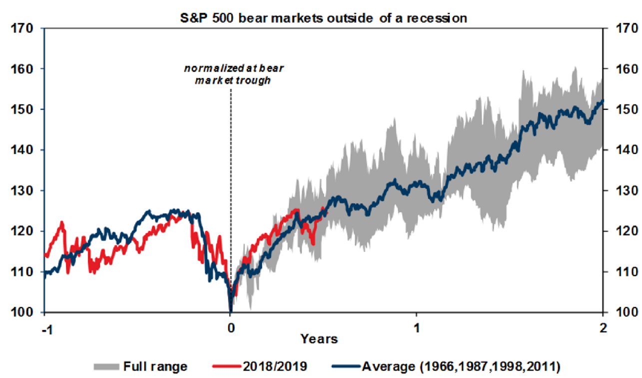


CIO Office (data via Refinitiv). *Next 12 months. ** U.S. 10-year notes minus 2-month T-bills. *** High yield minus Investment grade. As of June 28.

Equities: Halfway Through

U.S. Equities concluded the first half of 2019 almost spot-on the average ex-recession rebound pattern – June gains (+6.9%) roughly mirroring May losses (-6.6%) – following a script that continues to suggest further upside ahead (**Chart 9**).

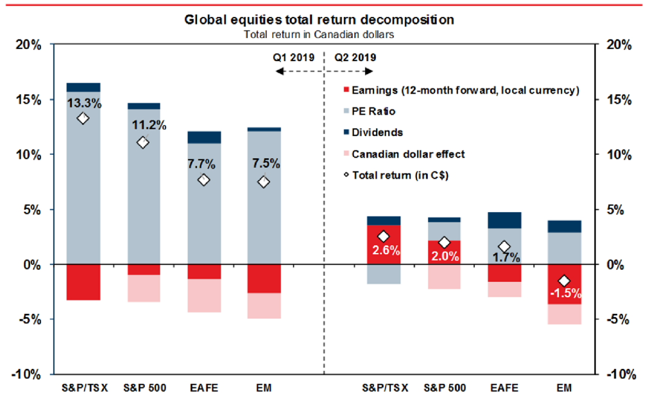
9 U.S. equities still following the script



CIO Office (data via Refinitiv).

After a record start to the year, it was therefore a quarter of modest returns and high volatility that concluded this last month, with performances in the low single-digit range for all regions but emerging markets. Digging further into the sources of total returns, we also note the positive contribution from earnings for North American indices in Q2 which did not occur abroad (**Chart 10**).

10 A little modesty for global equities in Q2

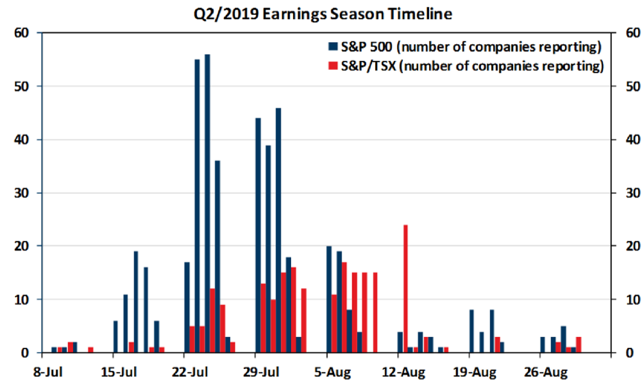


CIO Office (data via Refinitiv).

The next few weeks will tell whether corporate profits can live up to market participants' expectations, with earnings season just around the corner. Comments and forward guidance from corporations should be of particular interest as these should help us better assess the true consequences of the recent rise in U.S/China tariffs (**Chart 11**).

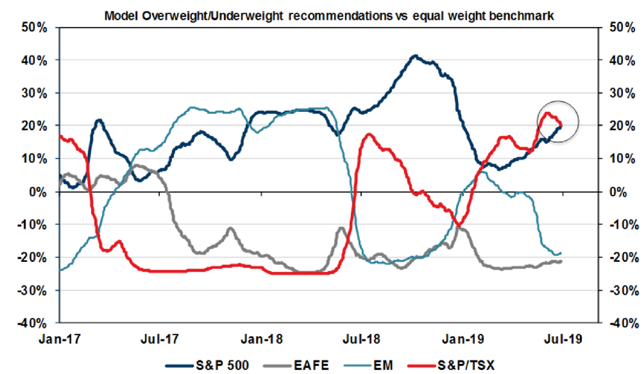
We continue to believe our geographical asset mix in favour of both U.S. and Canadian Equities is adequate, and this is what our Geographic Relative Momentum model continues to advocate (**Chart 12**).

11 Attention set to turn to corporate America in July



CIO Office (data via Refinitiv).

12 Our model continues to advocate for North America

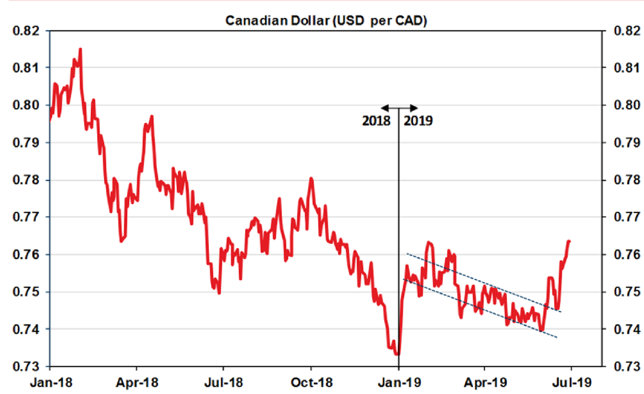


CIO Office (data via Refinitiv).

Currencies: Lift-Off

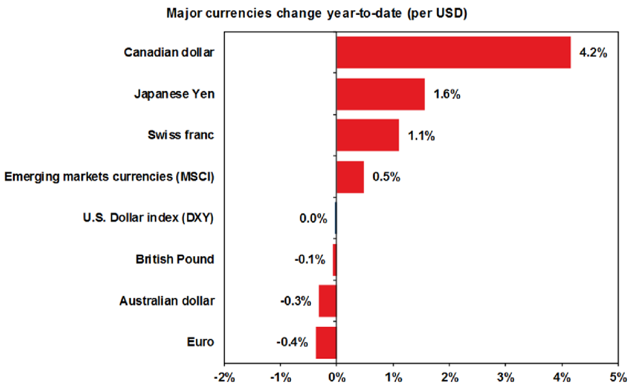
The Canadian dollar finally emerged from its torpor in June, lifting off from the steady downward trend of previous months (**Chart 13**) and making it the top-performing currency halfway through the year (**Chart 14**, next page).

13 The Canadian dollar emerged from its torpor in June...



CIO Office (data via Refinitiv).

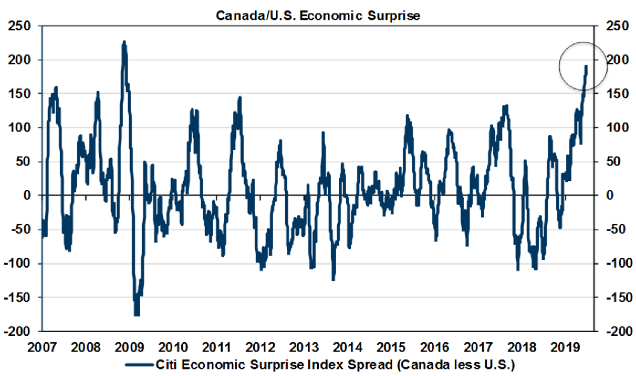
14 ...making it the top-performing currency in 2019



CIO Office (data via Refinitiv). As of June 29, 2019.

As we mentioned in our previous reports, the FX market made life hard for the Loonie for some time, refusing to reward the currency for strong economic surprises (which are still at a decade high relative to the U.S., **Chart 15**) and rising oil prices.

15 The Canadian economy continues to surprise *vs* the U.S.



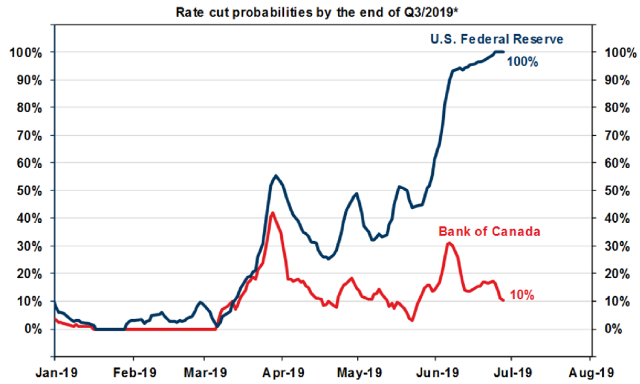
CIO Office (data via Refinitiv).

It is finally the Federal Reserve's June dovish shift that turned out to be the necessary boost for the currency pair to get off the ground, as markets now expect with certainty the U.S. Central Bank will soon retract at least one of its nine rate hikes this cycle, while the Bank of Canada should remain comfortably on the sidelines having only hiked its policy rate five times since 2017 (**Chart 16**).

These prospects have indeed resulted in a surge in the Canada/U.S. interest rate differential the likes of which we haven't seen since September 2017 – arguably the most important factor when it comes to currency valuation (**Chart 17**).

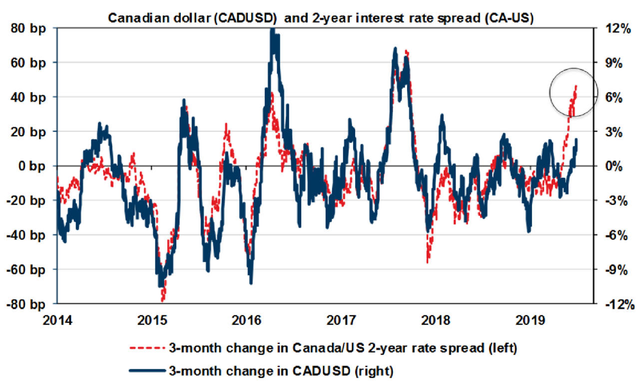
Going forward, we still foresee slight upside potential for the Loonie, with our colleagues from NBF Economics & Strategy targeting 1.29 USD/CAD (~0.78 US$ per C$) by the end of this quarter. However, considering the propensity of our currency to move in tandem with risk assets and the non-negligible probability of negative surprises on the trade front, some caution is advised in the short term.

16 *Potential* rate cuts are an American story...



CIO Office (data via Bloomberg). *Implied probabilities from fed funds futures in the U.S. (up until September 18 meeting) and overnight index swaps in Canada (up until September 4 meeting).

17 ...causing a surge in Canada/U.S. rate differentials

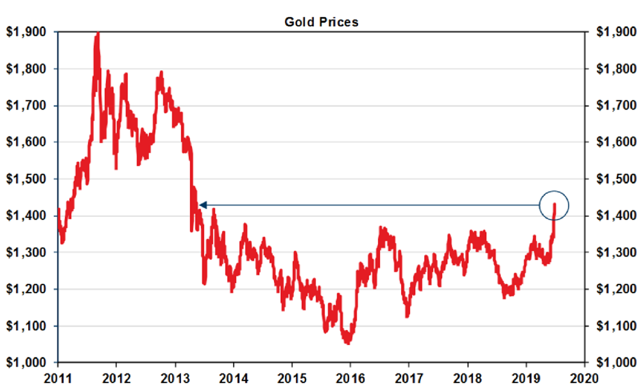


CIO Office (data via Refinitiv).

Commodities: Golden Rules

Gold prices surged all the way to a six-year high last month, delivering their strongest monthly price increase (+8.6%) since June 2016 (**Chart 18**).

18 Gold prices surged to a six-year high in June

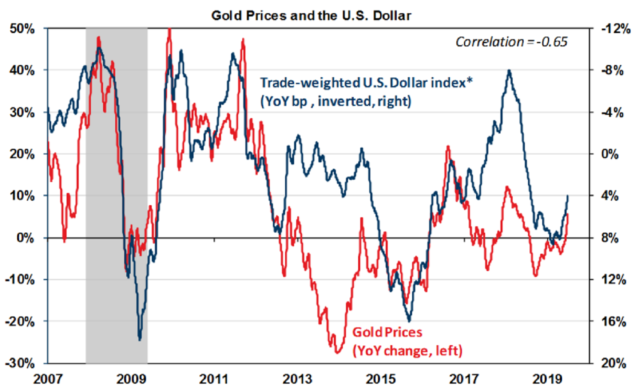


CIO Office (data via Refinitiv).

The precious metal is admittedly a tough nut to crack, with movements subject to fluctuations in investors' emotions, supply/demand/reserve data far less transparent than its energy peers, and production cost ranging widely from one mine to the other, not to mention a large community of eternal gold bugs that often share a passion for doomsday scenarios. There are nevertheless some situations where gold can do very well, and these mostly depend on two macroeconomic factors: (1) the U.S. dollar and (2) real yields.

In many ways, gold still shares the properties of a currency, which partly explains why it exhibits such a strong negative correlation with the U.S. dollar. The general rule is as the greenback depreciates, gold becomes cheaper to foreign buyers which, in turn, spurs demand from their end (all else remaining constant, of course). It does indeed seem that this dynamic somewhat took effect in June (**Chart 19**, with the U.S. dollar inverted).

19 First *golden rule* : ↓ U.S. Dollar = ↑ Gold

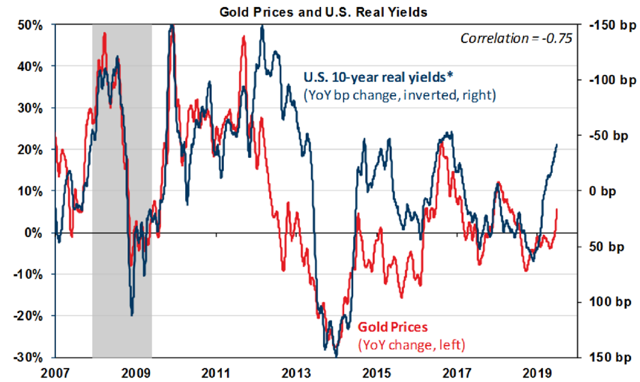


CIO Office (data via Refinitiv). *Broad U.S. Dollar index (26 pairs)

Fundamentally, it is important to understand that gold is deemed to follow inflation – hence its status of a "real" asset – but carries a negative yield in the form of storage costs. Consequently, the yellow metal will generally do very well in an environment where its opportunity cost is falling and inflation rising, that is, if real Treasury rates fall. Recently, it is not so much inflation as it is the sharp plunge in U.S. 10-year bond yields that explains the rapid rise in gold prices (**Chart 20**, with U.S. real yields inverted).

In few words, a play on gold is roughly equivalent to being short the Dollar, long Treasuries and long inflation: three positions that generally benefit from a dovish U.S. Federal Reserve. As such, for gold to climb much higher, we would need to see the Central Bank deliver more dovishness than markets currently expect (almost four rate cuts over the next twelve months), without a recession driving inflation to the ground and safe-haven flows spurring the greenback too much. Let's just say, this isn't our base-case scenario.

20 Second *golden rule* : ↓ Real rates = ↑ Gold



CIO Office (data via Refinitiv). *10-year U.S. government bond yields less 10-year breakeven inflation rate (i.e. 10-year TIPS yield).

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General

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