Like a Bull in a China Shop

Highlights

- The series of consecutive positive monthly returns for global equities recorded in the first four months of 2019 ended in May, with major stock indices ceding a fraction of their year-to-date gains. While that was partly offset by gains for fixed-income assets, it nevertheless resulted in a loss of 2.8% for a balanced portfolio.
- The main culprit is the escalation of the trade dispute which has had the world's two leading economies opposed for over a year now. We've repeated on many occasions that overreacting to geopolitical events is a common mistake by investors. But that doesn't mean that they should be outright ignored and, in the case of the ongoing trade spat, it must be recognized that the effects appear increasingly tangible.
- It is unclear whether the current U.S. administration carefully accounted for the element of fragility in the global economy when it chose to heat up trade tensions. If Trump's twitter feed is to be believed, the state of the U.S. equity market seems to influence the President's level of confidence in playing hardball. But perhaps he should broaden his horizon to the bond market, where investors have steadily grown pessimistic since the beginning of the year, now pricing nothing less than two rate cuts over the next twelve months.
- Under these circumstances, we downsized our equities position in favour of bonds in May. To be clear, our base case – with no recession in the cards, monetary policies far from restrictive, and decent valuations – continues to call for equities to outperform over the next twelve months. Rather, it is the increasing probability of a sustained trade conflict in the context of an already fragile late-cycle global economy, in addition to the asymmetry of outcomes should our bearish scenario materialize that justifies our tactical shift toward neutrality between asset classes.
- Back in April, we reviewed the implications of a yield curve inversion, concluding that it did provide further evidence of an aging business cycle without, however, heralding a recession right around the corner. Everything we said in that analysis still holds, but whatever one may think, the fact remains that the longer, deeper, and broader the inversion gets, the higher the chances are that history could repeat itself. Since the beginning of the year, our playbook for fixed-income assets has been to go up in quality and to increase duration closer to benchmark, in order to better gear portfolios in tandem with the increasingly fragile economic, monetary, and geopolitical environments - and we stand by our recommendation.
- We've brought some changes to our geographical mix in May, stepping up our allocation in North American equities, further downgrading EAFE assets, and reducing emerging markets to neutral – all of which are in line with our relative momentum model recommendations. It's important to understand that we are not applying these recommendations blindly, but rather using them as starting points in our asset mix decisions, which must then meet the usual macroeconomic, fundamental and risk/reward criteria. And, this is precisely what we go over, for each region, in the equities section this month.
- The loonie refused to break out of its slow but steady downward trend of the last few months, an observation is certainly not absent from the erosion of investors' risk appetite increasingly widespread between asset classes.

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

- Fixed-income indices finished higher in May, as investors increasingly sought a safer asset mix amid an environment of worsening Sino-American tensions.
- U.S. 10-year government bonds further rallied, pushing yields to their lowest level since September 2017 (down 37 bps in May) and causing a second yield curve inversion in as many months.

Canadian Equities

- Canadian equity outperformed both its U.S. and global peers in May, still ahead of the pack year-to-date.
- Unlike its neighbour to the south, some sectors did secure positive returns last month. Healthcare, Consumer Discretionary, were clear laggards (down 13.8% and 8.5% respectively), while Technology, Utilities, and Consumer Staples led the pack (up 4.3%, 3.5%, and 2.7% respectively).

U.S. Equities

- It was a rough month for U.S. equities as the S&P 500 crossed its 200-day moving average for the first time since its climb in January.
- Investors' eroding appetite for risk was apparent across U.S. sector performances, with cyclicals sinking the most while the more resilient defensive sectors held their losses to a minimum.
- With every sector but REITS turning red in May, the dubious award of worst performers fell to Energy (-11.1%) and Tech (-8.7%) stocks, the former falling prey to weakening oil prices, and the latter facing strong headwinds from the recent blacklisting of Huawei by the U.S. government driving fears of a possible tech war on the horizon.

Commodities

- Commodities did not escape the period's risk-off mood, with the Commodity Research Bureau (CRB) index ending the period down 1.5%.
- Last month put an end to oil's four-month hot streak, as prices fell 16.2% with the WTI closing out the period at 53.5$/bbl.
- Copper also took a cold spring shower, experiencing its sharpest monthly decline in 42 months at -9.7% for the period.

Foreign Exchange

- The Loonie remained on its slow but steady downward trend, finishing May 0.9% lower at 0.74 USD per CAD, as the American President's surprise declaration of new tariffs on all Mexican imports seemed to undermine hopes that the USMCA would quickly be ratified.
- Meanwhile, the U.S. Dollar Index (DXY) slightly appreciated (up 0.3%), favoured by the market's risk-off mood.

Table 2 Market Total Returns

Asset classes	May	YTD	12 months
Cash (3-month T-bills)	0.1%	0.7%	1.6%
Bonds (FTSE/TMX Ovr. Univ.)	**1.7%**	**5.6%**	**7.0%**
FTSE/TMX Short term	0.5%	2.5%	4.2%
FTSE/TMX Mid term	1.4%	5.4%	7.8%
FTSE/TMX Long term	3.4%	9.7%	10.2%
FTSE/TMX Government	1.8%	5.5%	7.2%
Federal	1.4%	3.7%	5.9%
Provincial	2.3%	7.3%	8.4%
Municipal	2.1%	6.9%	8.0%
FTSE/TMX Corporate	1.3%	5.7%	6.6%
AA+	0.7%	3.7%	5.4%
A	1.9%	6.7%	7.0%
BBB	1.3%	6.3%	6.9%
BoAML High-Yield (USD)	-1.3%	7.5%	5.4%
Preferred Shares	-3.0%	-1.7%	-9.9%
Canadian Equities (S&P/TSX)	**-3.1%**	**13.4%**	**3.0%**
Energy	-4.6%	14.3%	-6.2%
Industrials	-0.7%	19.1%	8.6%
Financials	-4.9%	11.1%	2.4%
Materials	-4.4%	1.2%	-9.5%
Utilities	3.5%	20.8%	20.3%
Cons. Disc	-8.5%	7.6%	-12.1%
Cons. Staples	2.7%	14.5%	23.8%
Healthcare	-13.8%	31.2%	18.2%
IT	4.3%	39.9%	29.9%
Telecom	1.8%	11.1%	17.9%
REITs	0.2%	14.8%	13.1%
S&P/TSX Small Cap	-4.2%	5.8%	-12.2%
US Equities (S&P500 USD)	**-6.4%**	**10.7%**	**3.8%**
Energy	-11.1%	3.5%	-20.0%
Industrials	-7.8%	12.5%	-1.0%
Financials	-7.2%	9.8%	-2.3%
Materials	-8.2%	5.0%	-7.3%
Utilities	-0.8%	11.0%	18.4%
Cons. Disc	-7.6%	13.0%	5.9%
Cons. Staples	-3.8%	10.4%	15.6%
Healthcare	-2.4%	1.3%	7.7%
IT	-8.7%	16.5%	4.4%
Telecom	-5.9%	14.2%	11.6%
REITs	1.2%	18.3%	19.9%
Russell 2000 (USD)	-7.9%	8.7%	-10.3%
World eq. (MSCI ACWI)	**-5.8%**	**9.4%**	**-0.8%**
MSCI EAFE (USD)	-4.7%	8.0%	-5.3%
MSCI EM (USD)	-7.2%	4.2%	-8.3%
Commodities (CRB index)	**-1.5%**	**1.7%**	**-6.8%**
WTI Oil (US$/barrel)	-16.2%	18.5%	-20.1%
Gold (US$/ounce)	1.3%	1.5%	-0.3%
Copper (US$/tonne)	-9.7%	-2.4%	-15.2%
Forex (DXY - US Dollar index)	**0.3%**	**1.6%**	**4.0%**
USD per EUR	-0.6%	-2.5%	-4.5%
CAD per USD	0.9%	-0.9%	4.3%

CIO Office (data via Refinitiv) 5/31/2019

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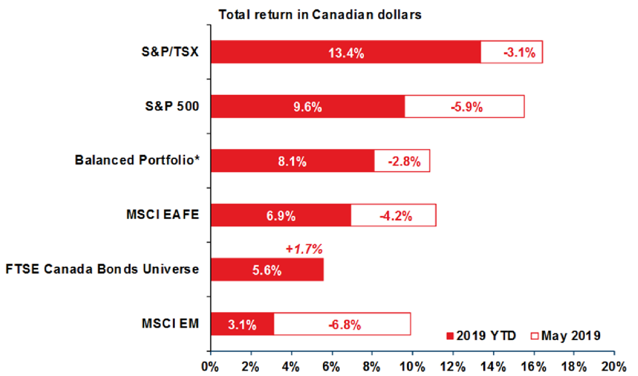
The series of consecutive positive monthly returns for global equities recorded in the first four months of 2019 ended in May, with major stock indices ceding a fraction of their year-to-date gains. While that was partly offset by gains for fixed-income assets, it nevertheless resulted in a loss of 2.8% for a balanced portfolio (**Chart 1**).

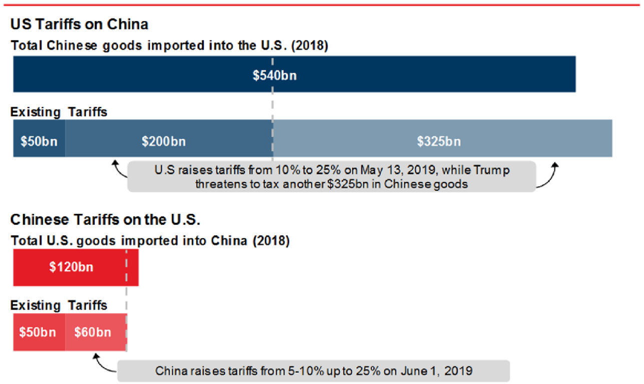
1 Risk assets eased back in May…



CIO Office (data via Refinitiv). *60% equities (21% S&P 500, 21% S&P/TSX, 12% MSCI EAFE, 6% MSCI EM), 40% bonds (FTSE Canada Bonds Universe).

The main culprit is the escalation of the trade dispute which has had the world's two leading economies opposed for over a year now. Indeed, just as markets expected Chinese and U.S. officials to announce some form of agreement, rather it was a new round of tariffs the Trump administration presented increasing import taxes to 25% from 10% on $200 billion worth of Chinese goods, threatened to place duties on another $325 billion, and accused Beijing of backtracking from previous concessions. Following this move by the U.S., China retaliated by raising tariffs on $60 billion worth of American products, only to see them extend the conflict into new territory, by putting Huawei on the Bureau of Industry and Security's "Entity List" (**Chart 2**).

2 …as tensions escalated between the U.S. and China



CIO Office (data via Refinitiv)

As if that were not enough, President Trump announced on the last day of May that his administration would deploy the same heavy artillery against Mexico, putting a 5% levy on all goods coming from its southern neighbour beginning on June 10, and threatening to bring tariffs gradually to 25% by October unless the migration "crisis" was "alleviated through effective actions taken by Mexico, to be determined in our sole discretion and judgment."

It wasn't all negative on the trade front in May, with Washington announcing that it would lift tariffs on Canadian steel and aluminum as well as delay for six months a decision on whether to impose tariffs on auto imports – a move of critical importance for Japan and Europe. Nevertheless, these developments are cold comfort in the context of a Sino-American trade conflict of far greater magnitude and the recent weaponization of tariffs on the U.S/Mexico border security battlefield.

We've repeated on many occasions that overreacting to geopolitical events is a common mistake by investors, as it often rhymes with selling low and missing the rebound. But that doesn't mean that they should be outright ignored. Typically, such events end up only temporarily affecting investor sentiment, without materially impacting the economy. But in the case of the ongoing trade spat, it must be recognized that the effects appear increasingly tangible.

For instance, the Federal Reserve of New York recently published a study where they estimated the total annual cost of the new round of tariffs to the typical U.S. household to be $831.[1] Similarly, the IMF estimated in a May 23 blog post that the ramping up of tariffs will subtract about 0.3% of global GDP in the short term, referring to 2019 as "a delicate year for the global economy."[2] Neither of these estimates are indicative of a recession, in and of themselves, but they do reflect a fragile economic backdrop, especially this late in the business cycle.

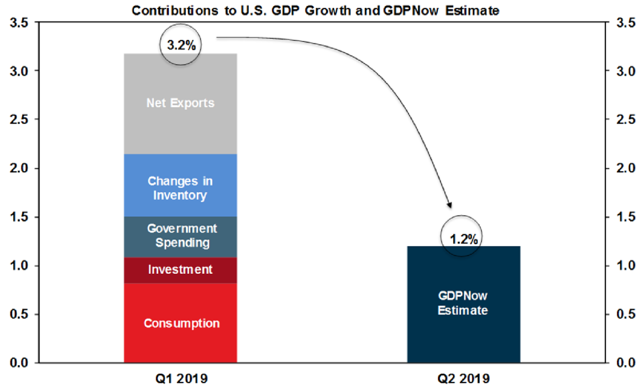
It is unclear whether the current U.S. administration carefully accounted for this element of fragility when it chose to heat up trade tensions. For one, Washington celebrated preliminary Q1 GDP growth figures back in April after coming out with a far better than expected, strong 3.2% annualized rate (revised to 3.1% on May 30). However, most of the growth surprise came from government spending and inventory accumulation; not the type of underlying data that points to a continuation of this pace, as evidenced by the Federal Reserve Bank of Atlanta GDPNow model estimate for Q2 (**Chart 3**, next page).

For another, if Trump's twitter feed is to be believed, the state of the U.S. equity market seems to influence the President's level of confidence in playing hardball. It is possible that he saw in the late April S&P 500 all-time-high munitions allowing him to escalate trade tensions – and, in fact, the stock market is still within the ex-recession range (**Chart 4**, next page). But, perhaps he should broaden his horizon to the bond market, where investors have steadily grown pessimistic since the beginning of the year, now pricing nothing less than two rate cuts over the next twelve months (**Chart 5**, next page).

[1] Mary Amiti, Stephen J. Redding, and David E. Weinstein, "New China Tariffs Increase Costs to U.S. Households," Federal Reserve Bank of New York Liberty Street Economics (blog), May 23, 2019.

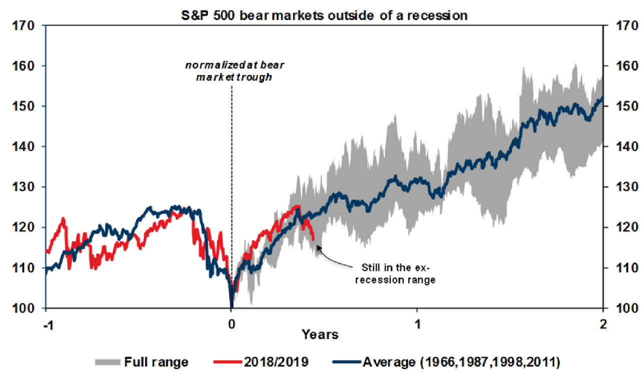
[2] Eugenio Cerutti, Gita Gopinath, and Adil Mohommad, "The Impact of US-China Trade Tensions," International Monetary Fund (blog), May 23, 2019.

3 **Extrapolating Q1 GDP growth is a mistake**



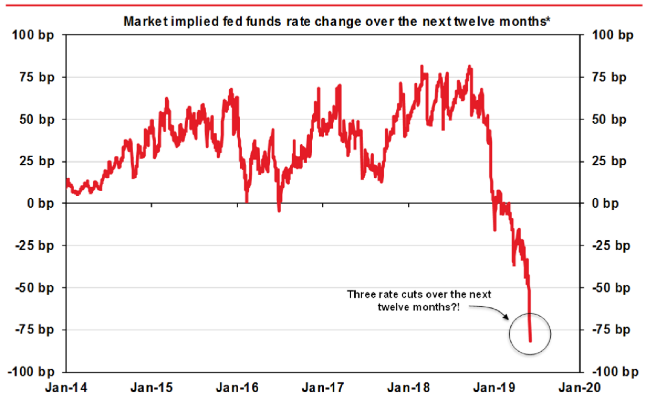
CIO Office (data via Refinitiv, Atlanta Fed)

4 **The stock market does not shout "Recession"...**



CIO Office (data via Refinitiv)

5 **... but the bond market increasingly does**



CIO Office (data via Bloomberg). *Difference between Fed Funds Futures (12-months) and currently effective fed funds rate.

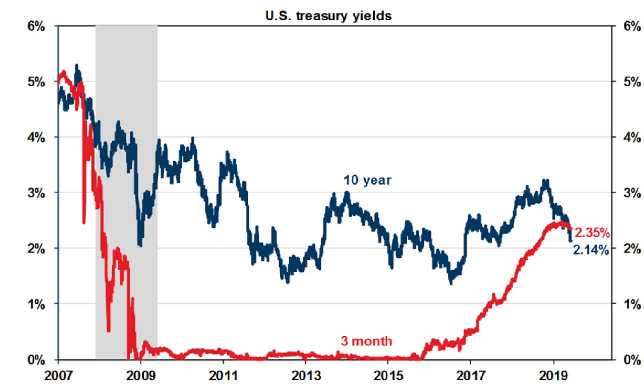
Under these circumstances, we downsized our equities position (from overweight to neutral) in favour of bonds (from underweight to neutral) in May, thereby reducing the overall risk from our asset allocation for a second time this year. To be clear, our base case with no recession in the cards, monetary policies far from restrictive, and decent valuations, continues to call for equities to outperform over the next twelve months. Rather, it is the increasing probability of a sustained trade conflict in the context of an already fragile late-cycle global economy in addition to the asymmetry of outcomes should our bearish scenario materialize that justify our tactical shift towards neutrality between asset classes. We've also introduced some changes to our geographical equity allocation, detailed further below in the equities section.

Over the next few weeks, we'll pay close attention to global economic figures (PMIs, consumer/business sentiment, job reports) to better assess how rising tariffs are affecting the "green shoots" we outlined in our previous asset allocation report. The Federal Reserve meeting of June 19, which will come with an updated rates projection, and any announcements from both the U.S. and Chinese leadership ahead of the June 28-29 G20 Summit are also of great importance.

Fixed Income: Pessimism Abounds

Pessimism continued to take hold of the bond market in May, with U.S. 10-year government bond yields falling 37 bps over the period, all the way down to a 9-month low of 2.14% and 21 bps into inversion territory (**Chart 6**).

6 **Back to inversion for the yield curve...**

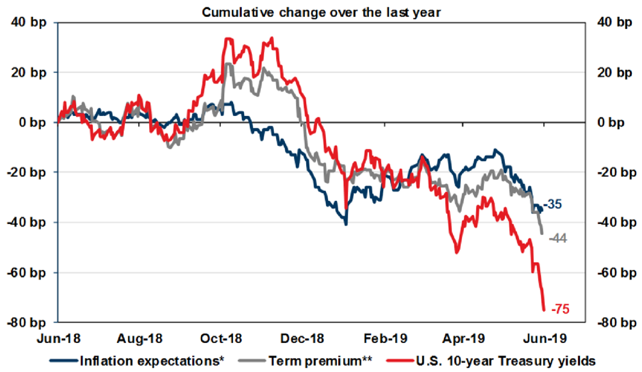


CIO Office (data via Refinitiv)

Two factors have undoubtedly contributed to this sharp decline: falling term premiums and lower inflation expectations (**Chart 7**, next page), the former reflecting an ever-growing appetite for safer assets, and the latter echoing concerns over global growth together with the ensuing retreat in crude oil prices (**Chart 8**, next page).

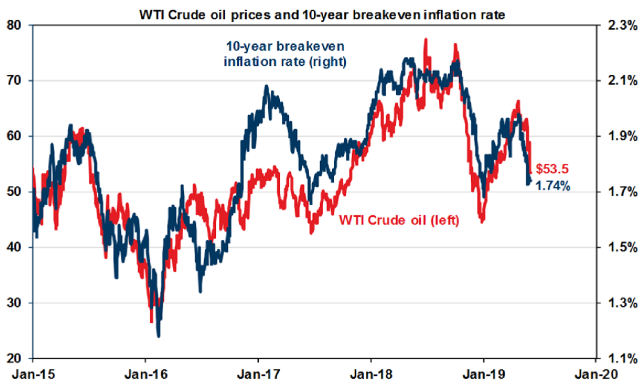
Back in April, we reviewed the implications of a yield curve inversion, concluding that it did provide further evidence of an aging business cycle without, however, heralding a recession right around the corner. Everything we said in that analysis still holds, but whatever one may think, the fact remains that the longer, deeper, and broader the inversion gets, the higher the chances are that history could repeat itself. With just a few weeks and a few basis points of inversion, it wouldn't be appropriate to push the recession button solely on this basis. But, we can't ignore the fact that the breadth of the yield curve inversion has recently reached a level calling for extra-caution (**Chart 9**, next page).

7 **… with falling term premiums and inflation expectations…**



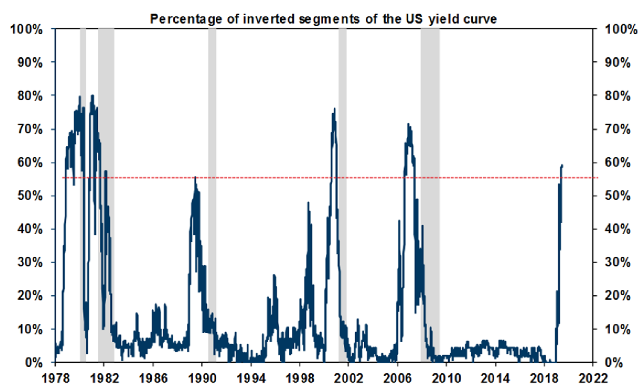
CIO Office (data via Refinitiv). *TIPS 10-year breakeven inflation rate. ** 10-year ACM term premium

8 **… echoing broader concerns over global growth**



CIO Office (data via Refinitiv)

9 **The breadth of the inversion calls for extra-caution…**



CIO Office (data via Refinitiv).
Maturities included = Effetive fed funds rate, 3m, 6m, 1y, 2y, 3y, 5y, 7y, 10y, 30y

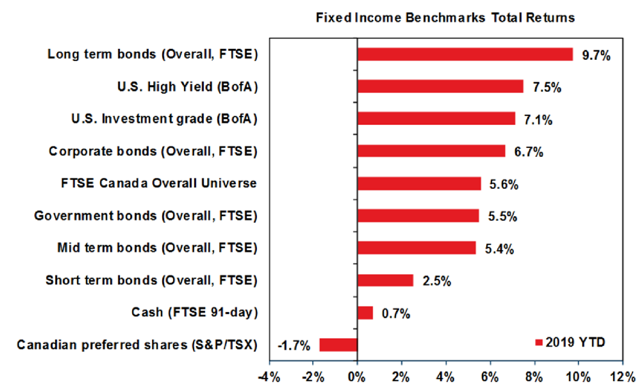
That said, this pessimism is not yet as readily apparent in the corporate credit sphere, an area where we continue to pay particularly close attention as we look for signs of a deteriorating investment backdrop. Both high-yield and BBB-rated corporate credit spreads did increase, but they remain near their historical median (**Chart 10**).

10 **…while credit spreads remain contained**

CIO Office (data via Refinitiv)

Since the beginning of the year, our playbook for fixed-income assets has been to go up in quality and to increase duration closer to benchmark to better gear portfolios in tandem with the increasingly fragile economic, monetary, and geopolitical environments.[3] Five months into 2019, U.S. high yields are standing up well with a 7.5% return, second only to long-term Canadian bonds, while preferred shares are lagging significantly behind (**Chart 11**) – and we stand by our recommendation.

11 **Ranking of fixed-income assets so far in 2019**



CIO Office (data via Refinitiv)

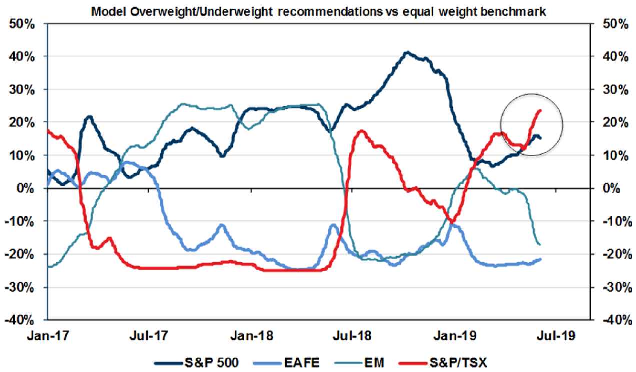
Equities: Shifting Trends

We've brought some changes to our geographical mix in May, stepping up our allocation in North American equities, further downgrading EAFE assets, and reducing emerging markets to neutral – all of which are in line with our relative momentum model (RMM) recommendations (**Chart 12**, next page).

Our avid readers will recognize this model, as we have mentioned it several times in our publications over the past year. Note that we will be publishing a more detailed report on the logic, methodology and historical performance of the RMM

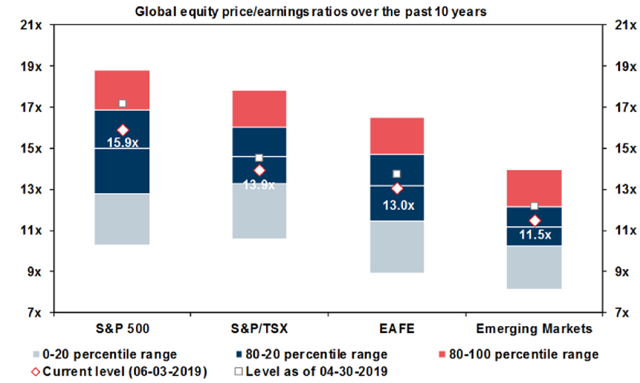
3 "From a windy 2018 to a stormy 2019?", NBI CIO Office, January 7, 2019.

12 Momentum = North America > Rest of the World



CIO Office (data via Refinitiv)

14 ... still at a (relative) valuation discount to peers

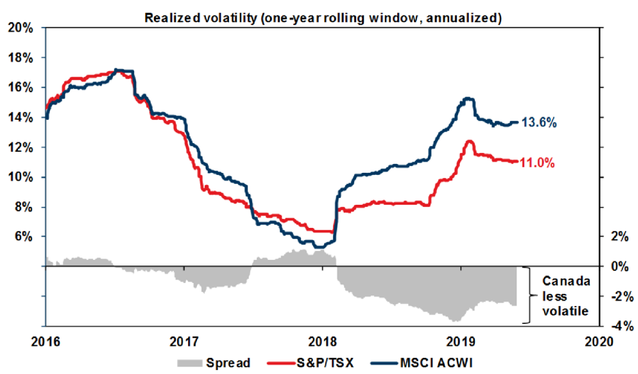


CIO Office (data via Refinitiv)

this summer. For now, it's important to understand that we are not applying its recommendations blindly, but rather are using them as starting points in our asset mix decisions, which must then meet the usual macroeconomic, fundamental and risk/reward criteria.

For Canada, our overweight positioning worked well since it was initiated in early February, the S&P/TSX Index having outperformed all three other main regions over the period. Back then, we argued that its lower volatility and lower valuations made it an attractive alternative in the current tense context. Both these arguments still hold, with realized volatility being at a fraction of that of the rest of the world since the start of 2018 (**Chart 13,**) and being the only region with a PE ratio significantly below its long-term average (**Chart 14**).

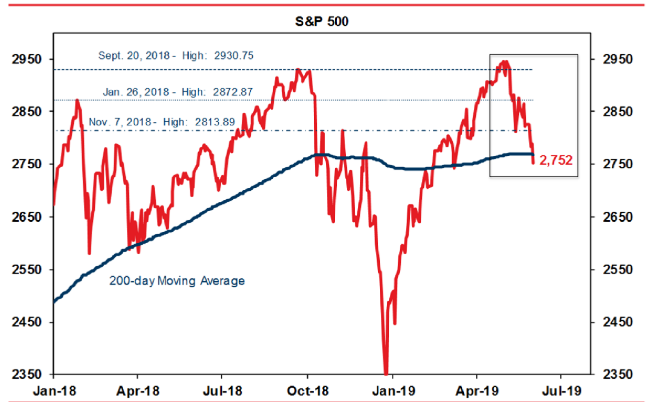
13 Canada: a *low-vol* choice in these volatile times...



CIO Office (data via Refinitiv)

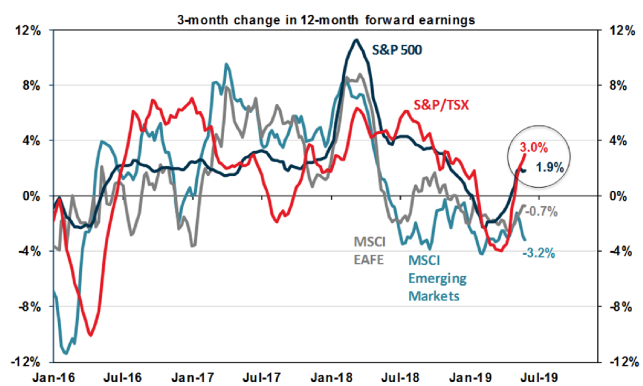
For their part, U.S. equities had all the appearance of a playground for technical analysts in May, with key levels acting like magnets, pushing and pulling the index with each successive news headline (**Chart 15**). We are encouraged by positive earnings revisions – which also hold true for Canada (**Chart 16**) – and weighted the natural counter-cyclical USD exposure they provide in our decision to overweight the S&P 500. We remain, however, fully conscious of the fact that

15 U.S. equities: a playground for technical analysts...



CIO Office (data via Refinitiv)

16 ...underpinned by resilient earnings growth



CIO Office (data via Refinitiv)

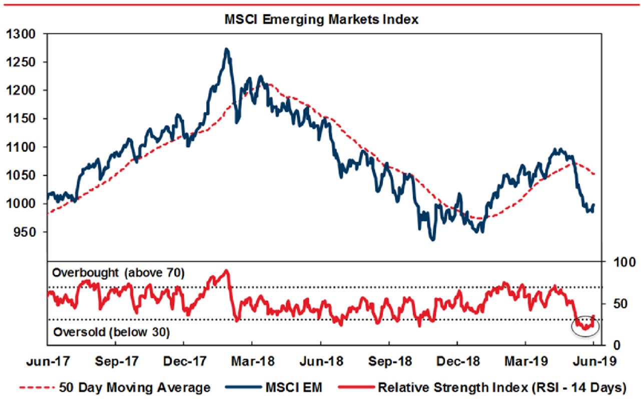
the index is far from immune from trade tensions and is likely to remain volatile.

In the EAFE region, prospects continue to pale in comparison, suffering from a high dependence on global trade and relatively weak growth figures, with both the Eurozone (47.7 vs. 47.9 in April) and Japan's (49.6 vs. 50.2) latest manufacturing

PMIs edging lower in contraction territory in May. This, along with monetary policy authorities stuck with little room to manoeuvre and persistently weak relative momentum, lead us to further downgrade the region, a position that has been profitable for us for a year now.

Finally, it must be recognized that the backdrop of emerging markets is far less clear-cut. On one hand, the two conditions that were outlined in previous reports for us to remain overweight in EMs have waned in recent weeks, namely in the form of weakening relative momentum and lack of clarity over trade negotiations. But, on the other hand, we shall not underestimate Chinese leadership's capacity to promptly inject stimulus should trade tensions further threaten their economy, while the index oversold conditions pointed to a rebound in the short term (**Chart 17**). As such, we brought our allocation in the region to neutral – versus the underweight recommendation from our model – and stand ready to readjust as the situation evolves.

17 Severe May for emerging markets

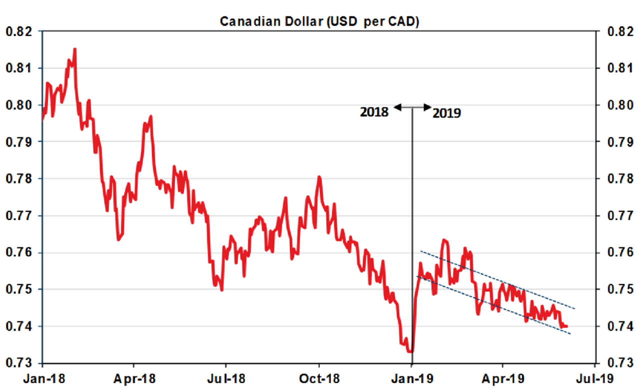


CIO Office (data via Refinitiv)

Currencies: Cross-Currents

The sharp rise in the Canadian dollar of early 2019 is an increasingly distant memory, the currency refusing to break out of its slow-but-steady downward trend of the last few months, having lost 0.9% in May (**Chart 18**).

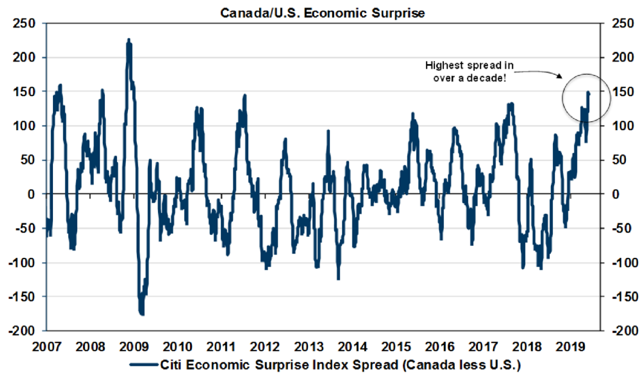
18 Slow-but-steady downward trend for the loonie...



CIO Office (data via Refinitiv)

And yet, economic figures can hardly be blamed, with the spread between Canada and the U.S. economic surprise index having reached nothing less than its highest point in over a decade (**Chart 19**).

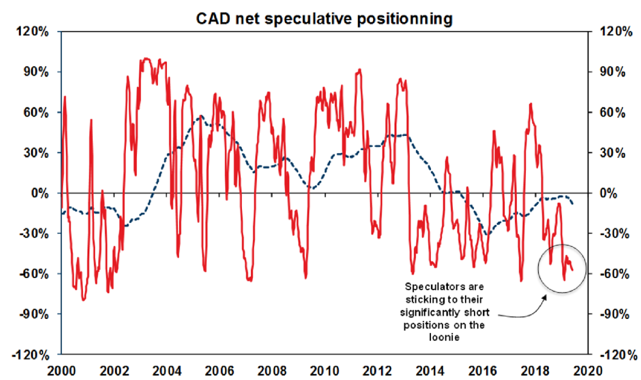
19 ... in spite of record economic surprises...



CIO Office (data via Refinitiv)

Rather, it seems to be investors' scepticism over the likelihood of the current backdrop translating into genuine fund flows to Canada that is holding the Loonie grounded, with speculators sticking to their significantly short positions on the currency pair (**Chart 20**).

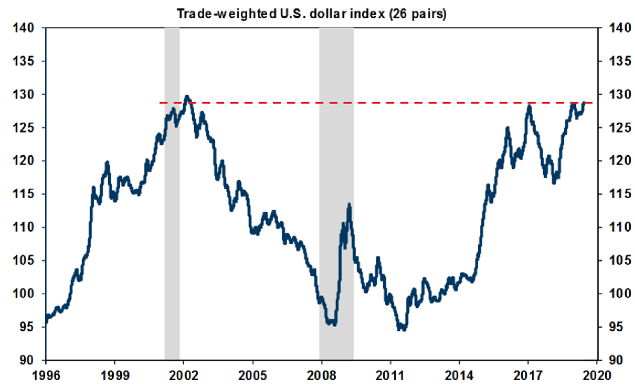
20 ... as speculators remain significantly short the currency



CIO Office (data via Refinitiv)

This observation is certainly not absent from the erosion of investors' risk appetite seen in the bond market for some time and increasingly widespread in other asset classes, the greenback benefitting from its safe-haven status in such conditions. For instance, the trade-weighted U.S. Dollar Index has climbed back up to its December 2018 top in May, a trend that poses the risk of weighing on S&P 500 earnings and emerging market economies should it accelerate (**Chart 21**, next page).

21 Rising U.S. Dollar: a "risky" trend



CIO Office (data via Refinitiv)

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