NATIONAL BANK INVESTMENTS

ASSET ALLOCATION STRATEGY | March 2019

Gear change

Highlights

- After a series of record-breaking monthly returns – both up and down – February saw a return to normality for global equities, with the Federal Reserve and the U.S. Administration doing their utmost to put out the fires they initially lit. Indeed, the Central Bank confirmed it remains in watch mode, while President Trump postponed the threat of increasing tariffs on Chinese products from 10% to 25% in light of trade talks progress.
- With an all-out trade war scenario less and less likely and the threat of an overly aggressive Federal Reserve essentially off the table, the focus should shift to a closely related, but arguably more important matter: the global economic slowdown.
- The latest economic data releases are unequivocal: the global economy is shifting down a gear amid uncertain times, but we see nothing beyond what was expected for 2019. Additionally, it should not be forgotten that global equities have been discounting a lot of bad news over the past twelve months. From now on, at a minimum, the rebound in equity prices will need to be matched by stabilization of macroeconomic indicators for it to continue, which is precisely what we expect over the next few months.
- Now, that doesn't mean to say that stocks won't face any hurdles from this point on, especially considering the string of good news markets have enjoyed since the beginning of the year as well as the approach of key technical levels. But for us to cut risks to our tactical allocation once more, we would need to see a clear sign of excessive optimism, something we haven't witnessed just yet.
- While risk assets reflect a resurgence of moderate optimism, the same cannot be said of U.S. Treasury yields, as weakening U.S. growth prospects appear to have prevented 10-year rates from responding to the modest rebound in inflation expectations. By year-end, our base case scenario continues to call for government bond yields to climb marginally higher against a backdrop of higher inflation, stabilizing growth prospects and, ultimately, one more rate hike by the Federal Reserve. However, this story is unlikely to materialize before the second half of this year.
- Mirroring interest rates, the currency market has not been particularly volatile lately, with the U.S. dollar index flat year-to-date and the Loonie back to last November's levels. Looking ahead, the global economic backdrop should continue to support the Canadian dollar.
- Putting aside the effect of currencies, the race higher by global equities has been a tight one year-to-date. With price-to-earnings multiples now close to their historical averages and sales growth expectations similar from one region to another, it does indeed seem that a tight race between Canadian, EM, and U.S. stocks is set to continue: precisely what our relative momentum model also suggests. Under these circumstances, we remain comfortable with our modest geographical tilts and stand by ready to increase our deviations should clearer trends emerge.
- For crude oil, the tug-of-war between OPEC's supply cuts and mounting U.S. production should continue but, at the end of the day, the key factor will be demand robustness, which we expect to remain supportive.

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

> In contrast with its riskier counterpart, U.S. and Canadian bond yields failed to move significantly in February, leading to more muted performance for fixed-income benchmarks.

> In a sign that the Fed's wait-and-see stance has helped settle markets, credit spreads fell progressively lower, resulting in a 1.7% total return for high-yield corporate debt over the month.

Canadian Equities

> While not equal to its Rockstar-like January performance, this past month still saw the S&P/TSX gain a respectable 3.1%, allowing it to maintain its lead over international peers year-to-date (in C$).

> All sectors, save for one, posted positive returns in February, with Information Technology clearly ahead of the pack finishing the month with a gain of 8.4%.

> On the other hand, Materials failed to impress, closing out the shortest month of the year 0.7% in the red.

U.S. Equities

> The S&P 500 index climbed another 3.2% in February, supported in part by easing trade tensions and a more patient Fed, as well as close to 70% of companies reporting an earnings beat (with only 9% of companies left to report).

> Owing to this string of good news, all sectors reported positive performances, with Information Technology and Industrials leading the pack (6.9% and 6.4% respectively).

Commodities

> Oil's sharp change in direction away from its 2018 Q4 lows continued in February, with the commodity gaining on the back of further announced cuts from OPEC+Russia and a deteriorating situation in Venezuela.

> Copper, a natural barometer for the global health of the economy, also gained greatly over the last month (6.6%) while its shinier brother, gold, remained relatively flat.

Foreign Exchange

> February was a month of relative calm for Forex markets, save for the rollercoaster ride that was the British Pound. On fears of a hard Brexit resurging earlier in the month, the GBP fell to a low of $1.28, followed by a rally to 1.33$ upon P.M. May's concession that the Brexit deadline might, in fact, need to be pushed back.

> The Loonie weakened marginally last month, although it remains up 3.4% since the beginning of the year, propelled by stronger commodity prices.

> For its part, the U.S. dollar index strengthened slightly in February, reversing some of the loses incurred the month before.

Table 2 Market Total Returns

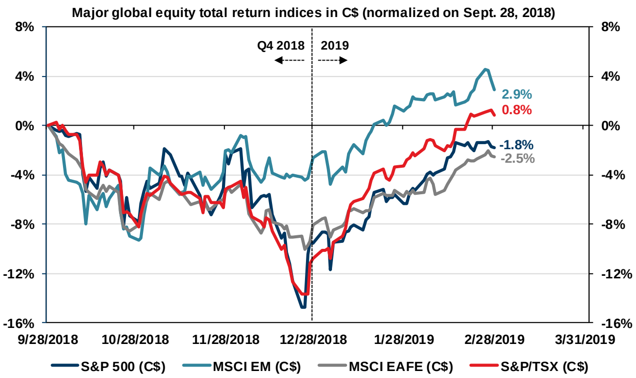
Asset classes	February	YTD	2018
Cash (3-month T-bills)	0.1%	0.3%	1.4%
Bonds (FTSE/TMX Ovr. Univ.)	**0.2%**	**1.5%**	**1.4%**
FTSE/TMX Short term	0.2%	0.9%	1.9%
FTSE/TMX Mid term	0.2%	1.6%	1.9%
FTSE/TMX Long term	0.1%	2.3%	0.3%
FTSE/TMX Government	0.1%	1.3%	1.5%
Federal	-0.1%	0.6%	2.4%
Provincial	0.3%	2.1%	0.7%
Municipal	0.4%	1.9%	0.9%
FTSE/TMX Corporate	0.3%	2.0%	1.1%
AA+	0.3%	1.4%	1.8%
A	0.1%	2.0%	0.5%
BBB	0.4%	2.4%	1.0%
BoAML High-Yield (USD)	1.7%	6.4%	-2.3%
Preferred Shares	2.1%	1.6%	-7.9%
Canadian Equities (S&P/TSX)	**3.1%**	**12.2%**	**-8.9%**
Energy	4.8%	16.0%	-18.3%
Industrials	3.5%	11.2%	-2.4%
Financials	3.0%	11.8%	-9.3%
Materials	-0.7%	6.0%	-9.3%
Utilities	4.4%	11.0%	-8.9%
Cons. Disc	0.2%	11.0%	-16.0%
Cons. Staples	3.4%	7.0%	2.0%
Healthcare	2.1%	46.3%	-15.9%
IT	8.4%	19.3%	13.0%
Telecom	2.7%	7.3%	-0.8%
REITs	4.9%	13.3%	2.0%
S&P/TSX Small Cap	4.0%	11.9%	-18.2%
US Equities (S&P500 USD)	**3.2%**	**11.5%**	**-4.4%**
Energy	2.6%	14.0%	-18.1%
Industrials	6.4%	18.6%	-13.3%
Financials	2.4%	11.5%	-13.0%
Materials	3.3%	9.0%	-14.7%
Utilities	4.2%	7.7%	4.1%
Cons. Disc	0.8%	11.2%	0.8%
Cons. Staples	2.3%	7.6%	-8.4%
Healthcare	1.2%	6.1%	6.5%
IT	6.9%	14.3%	-0.3%
Telecom	0.8%	11.3%	-12.5%
REITs	1.1%	12.0%	-2.2%
Russell 2000 (USD)	5.1%	16.8%	-12.2%
World eq. (MSCI ACWI)	**2.7%**	**10.9%**	**-8.9%**
MSCI EAFE (USD)	2.6%	9.3%	-13.4%
MSCI EM (USD)	0.2%	9.0%	-14.2%
Commodities (CRB index)	**0.0%**	**0.9%**	**-5.4%**
WTI Oil (US$/barrel)	6.3%	26.7%	-25.3%
Gold (US$/ounce)	-0.5%	2.7%	-1.7%
Copper (US$/tonne)	6.6%	10.2%	-17.5%
Forex (DXY - US Dollar index)	**0.6%**	**0.0%**	**4.4%**
USD per EUR	-0.8%	-0.4%	-4.8%
CAD per USD	0.3%	-3.4%	8.4%

Source: Datastream 2/28/2019

Gear Change

After a series of record-breaking monthly returns – both up and down – February saw a return to normality for global equities, with the MSCI All-Country World Index (ACWI) delivering a respectable 2.7% gain during this relatively quiet period. From a Canadian investors' perspective, this means both the S&P/TSX and emerging markets (EM) equities have already more than made up for the heavy losses suffered in Q4 of last year, while the S&P 500 and MSCI EAFE appear close to bridging the gap (**Chart 1**).

1 Q4/2018: An increasingly distant memory



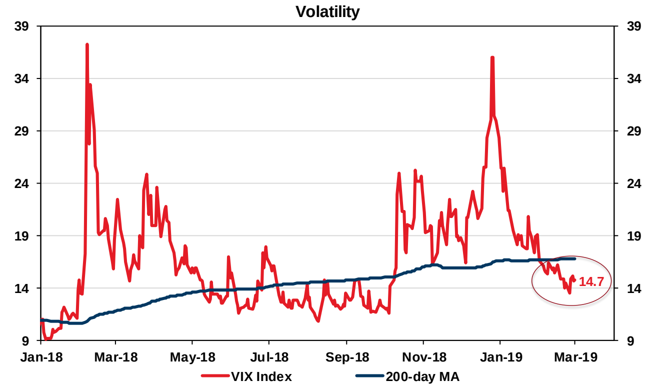
CIO Office (data via Refinitiv)

This outcome is partly explained by the fact that the usual suspects of recent market volatility – the Federal Reserve and the U.S. Administration – have done their utmost to put out the fires they initially lit. For instance, Minutes to the January FOMC meeting confirmed the Central Bank remains in watch-mode and that it intends to announce a plan to stop reducing the Federal Reserve's asset holdings later this year. As for Washington, President Trump averted another government shutdown by signing a bipartisan funding bill on February 15, in addition to postponing the threat of increasing tariffs on $200 billion worth of Chinese products from 10% to 25%, in light of trade talks progress. Accordingly, the U.S. Equity Volatility Index (VIX) held below its 200-day moving average during most of last month, a first since October of last year (**Chart 2**).

To be clear, this does not mean we are done hearing about trade tensions. For one, the Trump Administration has yet to clarify its intentions regarding potential auto import tariffs, especially threatening for Japan and Germany. For another, the USMCA trade agreement (i.e. new NAFTA), although signed by the three heads of state, remains unratified, while U.S. tariffs on steel and aluminum imports imposed on the pretext of a national security threat are still in force.

In addition, a summit meeting between Chinese leader Xi Jinping and President Trump to seal a Sino-U.S. trade agreement is still conditional on "additional progress" being made, a fact

2 A return to calm courtesy of the Fed and Washington



CIO Office (data via Refinitiv)

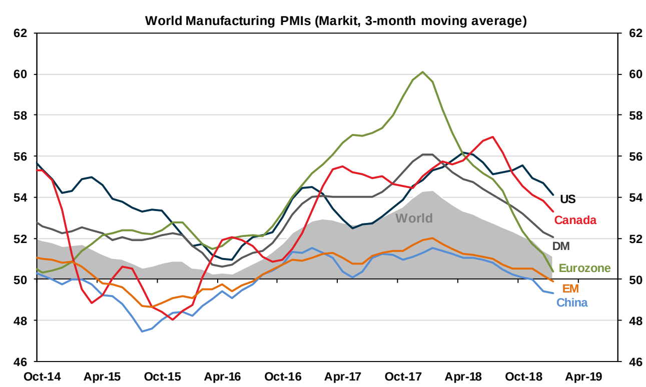
reinforced by U.S. Trade Representative Robert Lighthizer's comments to Congress on February 27:

> *"There's no agreement on anything until there is agreement on everything"*

But, as we wrote last month, Trump's capacity and willingness to play hardball has diminished quite significantly in recent months, and the latest news suggests that the worst of the tariffs spat does indeed seem to be behind us.

Therefore, with an all-out trade war scenario less and less likely and the threat of an overly aggressive Federal Reserve essentially off the table, the focus should shift to a closely related, but arguably more important matter: the global economic slowdown (**Chart 3**).

3 Gear change for the global economy...

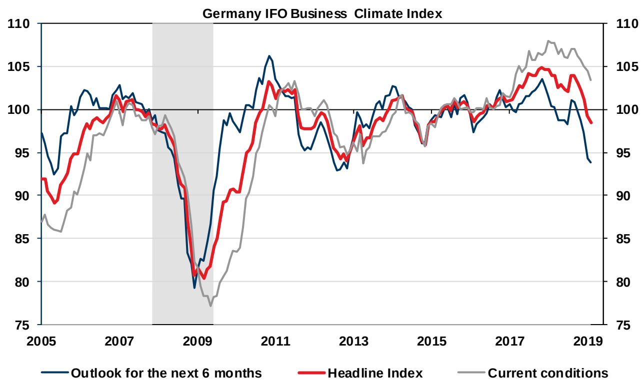


CIO Office (data via Refinitiv)

North America is holding rather well for now. The latest employment reports were quite compelling, with Canada and the U.S. respectively adding 67k and 304k new jobs in January, while U.S. GDP figures once again surprised to the upside, up 2.6% in 2018 Q4.

The context seems more challenging on the Old Continent. Germany just narrowly avoided a technical recession – defined as two successive quarters of contraction – provoking debate as to what fraction of the slowdown is attributable to transitional factors (e.g. new car regulations and low water levels in the Rhine) or to weakening international trade. In any case, the latest business confidence data from Europe's biggest country dropped to a four-year low, an unambiguous reflection of the many sources of uncertainty, whether it be trade tensions or Britain's looming departure from the EU (**Chart 4**).

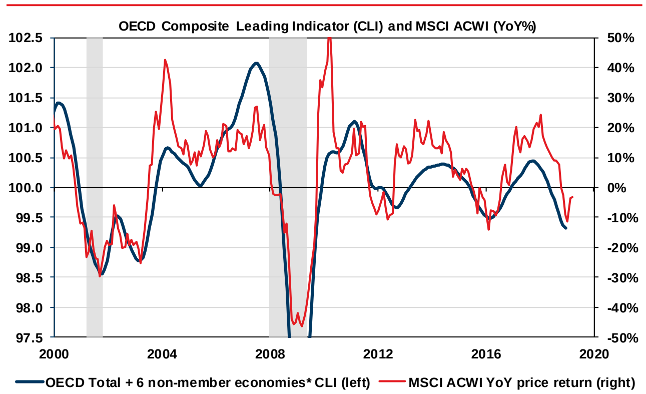
4 ...especially acute on the Old Continent...



CIO Office (data via Refinitiv)

So, the global economy is clearly shifting down a gear amid uncertain times - that is undeniable. For now though, we see nothing beyond what was expected for 2019, and our colleagues from NBF Economics and Strategy continue to foresee 2019 world GDP growth at 3.5%, compared to 3.7% in 2018. Additionally, it should not be forgotten that global equities – which are forward-looking by definition – have been discounting a lot of bad news over the past twelve months, including the current economic slowdown. After all, despite a strong start to 2019, the MSCI ACWI is still negative on a year-over-year basis in a manner reminiscent of the 2012 and 2016 soft patches (**Chart 5**).

5 ...but largely discounted by global equities

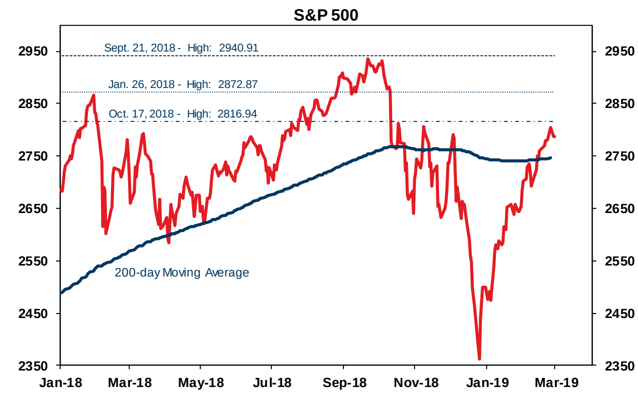


CIO Office (data via Refinitiv)

From now on, at a minimum, the rebound in equity prices will need to be matched by stabilization of macroeconomic indicators in order for it to continue, and this is precisely what we expect over the next few months.

Now, this doesn't mean to say that stocks won't face any hurdles from this point on, especially considering the string of good news markets have enjoyed since the beginning of the year. If only on a technical basis, the S&P 500's mid-October and November tops should offer their fair share of resistance, followed by January 2018's peak and, ultimately, its all-time high of 2941 reached on September 21, 2018 (**Chart 6**).

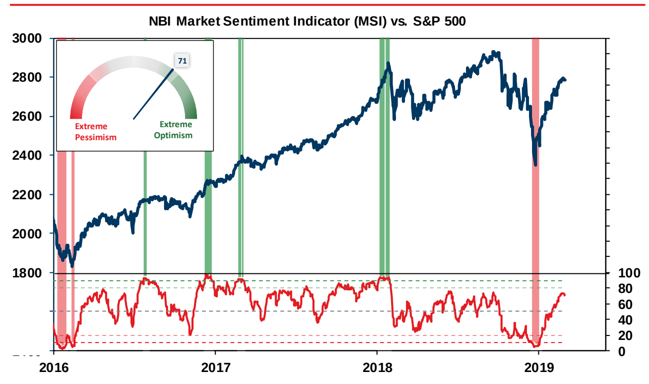
6 Resistance ahead: Time to digest the string of good news?



CIO Office (data via Refinitiv)

Nevertheless, these are among the very reasons why we chose to trim our allocation to U.S. equities in early February. For us to cut risks to our tactical allocation once more, we would need to see a clear sign of excessive optimism, something we haven't seen just yet (**Chart 7**). Under these circumstances, we begin March with our asset allocation unchanged.

7 Growing optimism still shy of exuberance

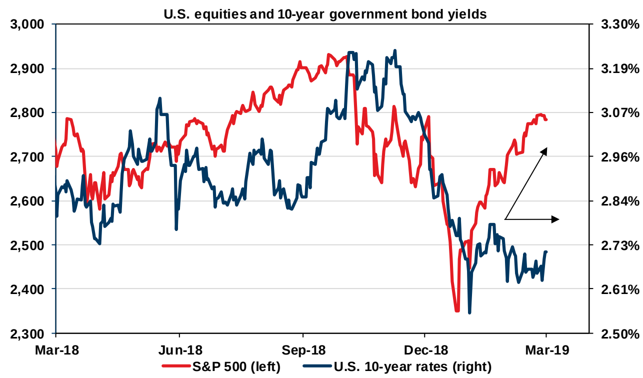


CIO Office (data via Refinitiv)

Fixed Income: What rebound?

While equity markets reflect a strong resurgence of optimism, the same cannot be said of U.S. Treasury yields, which are still holding near December 2018 levels and just 11 basis points below where they were 12 months ago (**Chart 8**).

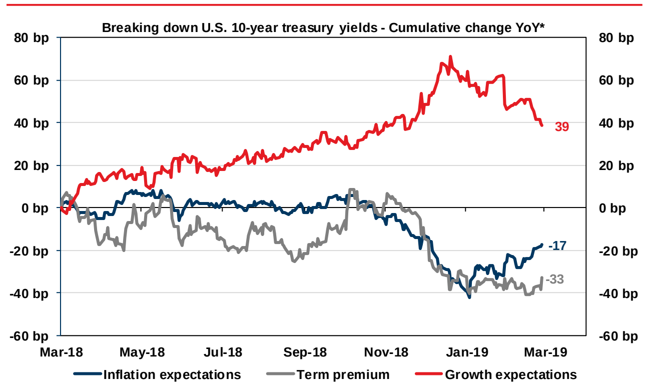
8 What is happening with U.S. 10-year rates?…



CIO Office (data via Refinitiv)

How is that possible given all that has happened since then? The truth is, much has occurred behind the scenes, as depicted by a simple breakdown of 10-year yields into three components: (1) growth expectations; (2) inflation expectations; and (3) a term premium. Indeed, it is evident that weaker inflation expectations (brought down by plunging oil prices) and a falling term premium (with rising global uncertainty causing markets to rule out further rate hikes) are the main culprits behind the decline in Q4/2018. Since then, it is rather weakening U.S. growth prospects that appears to have prevented 10-year rates from responding to the modest rebound in inflation expectations, while the Federal Reserve's wait-and-see stance is arguably holding the term premium steady (**Chart 9**).

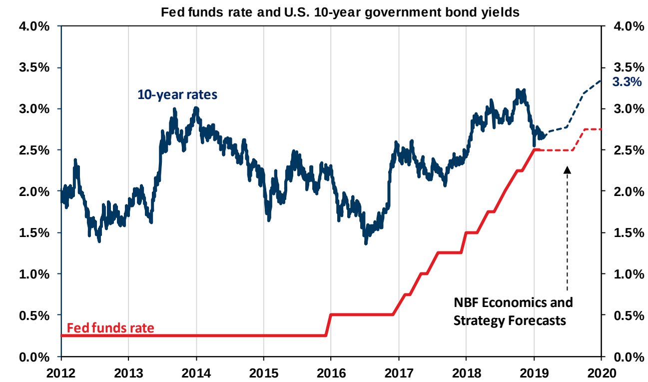
9 …a lot …if you look under the hood…



CIO Office (data via Refinitiv)
*Inflation expectations = 10-year U.S. Breakeven inflation rates, Term premium = ACM term premium, Growth expectations = Residual (i.e. Nominal yiels less inflation expectations and term premium)

By year-end, our base case scenario continues to call for government bond yields to climb marginally higher against a backdrop of higher inflation, stabilizing growth prospects and, ultimately, one more rate hike by the Federal Reserve (**Chart 10**).

10 …but probably not much over the coming months



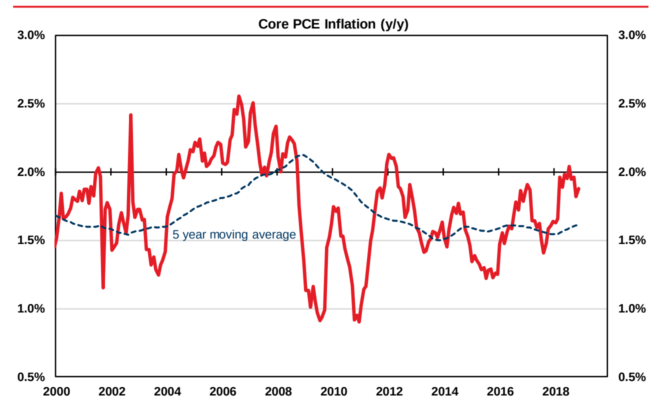
CIO Office (data via Refinitiv)

However, this story is unlikely to materialize before the second half of 2019, given a still-uncertain geopolitical backdrop and fairly limited inflationary pressure in the short term, as best summarized by Governor Powell in front of lawmakers on the Senate Banking Committee on February 26:

> *"With our policy rate in the range of neutral, with muted inflation pressures and with some of the downside risks we've talked about, this is a good time to be patient and watch and wait and see how the situation evolves."*

It is important to remember that the Federal Reserve's preferred measure of inflation has trended below target 75% of the time since the turn of the millennium, and 95% of the time since the Great Financial Crisis. The Central Bank sure can afford to be patient (**Chart 11**). Under these circumstances, we reiterate that the need for shorter-duration products is becoming less relevant for fixed-income portfolios.

11 The Central Bank sure can afford to be patient

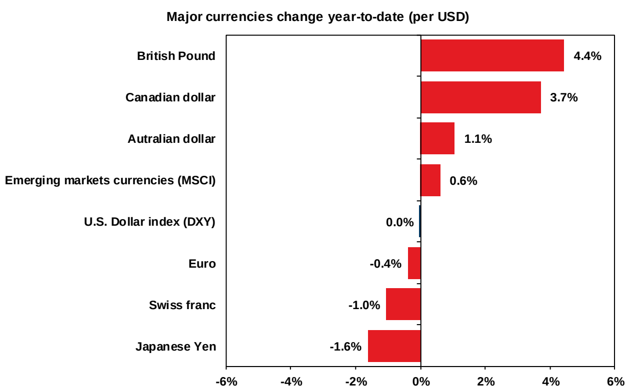


CIO Office (data via Refinitiv)

Currencies: Smooth Sailing

Mirroring interest rates, the currency market has not been particularly volatile lately, with the U.S. dollar index (DXY) showing zero change since the beginning of the year. Yet again, an interesting dynamic lies beneath this flat figure, with the British Pound propelled 4.1% higher than its intra-month low on the back of a possible delay to Brexit, and safe-haven currencies (Japanese Yen and the Swiss Franc) retreating in parallel with an easing in global uncertainties (**Chart 12**).

12 Don't ask King dollar for a story… he is a zero

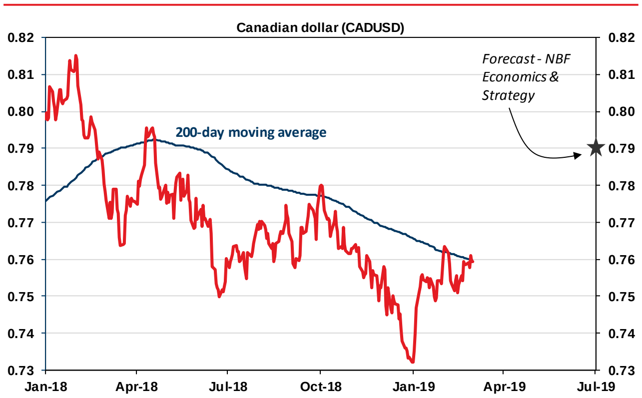


CIO Office (data via Refinitiv)

From our perspective, the most important movement is obviously the Loonie's 3.4% climb year-to-date, most of which appears to come from the rebound in cyclical assets, as the Bank of Canada is understandably sticking to the prudent monetary policy stance of its big brother south of the border.

While this is a considerable rise for the Canadian dollar, it should not be forgotten that this gain simply brings it back to last November's levels and is still 2.6% lower than a year ago (**Chart 13**).

13 The loonie still has some distance to travel



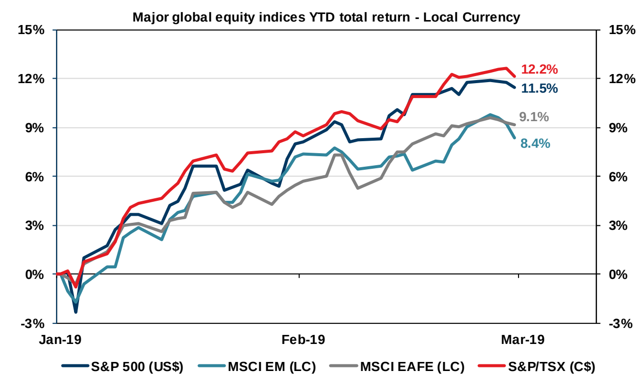
CIO Office (data via Refinitiv)

Looking ahead, our expectations that global economic indicators stabilize and that trade tensions ease should continue to support the Loonie. According to NBF Economics and Strategy, this entails a USD/CAD mid-year target of 1.27 (0.79 USD per CAD).

Equities: A Tight Race

Putting aside the effect of currencies, the race higher has been a tight one year-to-date, with North American equities competing hard for pole position, followed closely behind by international stocks (**Chart 14**).

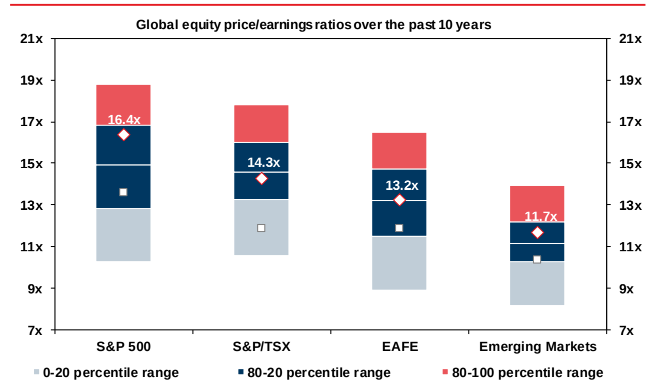
14 Tight race for global equities after two months…



CIO Office (data via Refinitiv)

This rally has driven valuations up and away from their lows of last Christmas Eve, albeit not yet to ominous levels. For instance, looking at the historical range of price-to-earnings ratios in the current cycle (i.e. the last 10 years), we can see that both Canada and EAFE multiples are now roughly equal to their averages, while only the S&P 500 (1.5x points above average) and, to a lesser extent, emerging markets (EM, 0.5x points above average) are nearing their top quintiles (**Chart 15**).

15 …fuelled by a recovery in valuation multiples…

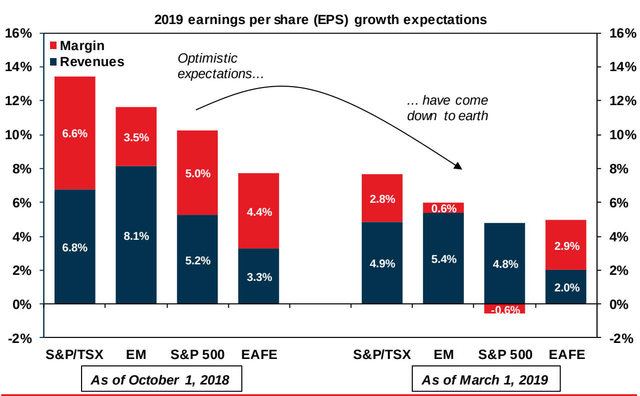


CIO Office (data via Refinitiv)

In other words, global equities appear to be reasonably valued, although the S&P 500 looks relatively more vulnerable to a rapid shift in investor sentiment, as pointed out last month when we brought back U.S. stocks from overweight to neutral.

The reassuring fact, however, is that these valuation multiples are measured against earnings expectations which have moderated significantly over the last few months, now at levels that we consider to be much more realistic (**Chart 16**). Another positive is the majority of EPS revisions were actually margin revisions – especially so in the U.S. – which makes a lot more sense in this context of rising wages and the waning effect of tax cuts.

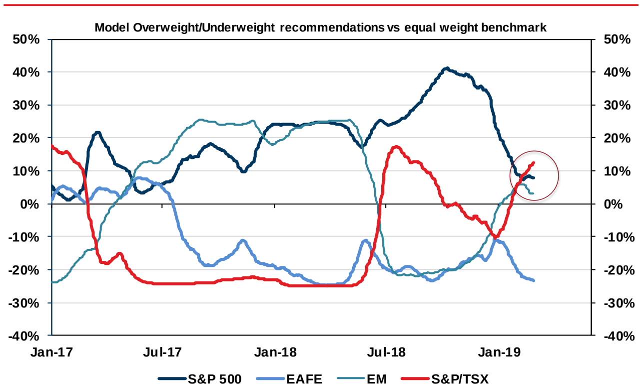
16 ...measured against *down-to-earth* EPS expectations



CIO Office (data via Refinitiv)

As to which region will lead in the coming months, should sales growth expectations hold, it does indeed seem that a tight race among EM (+5.4% sales growth expected in 2019), Canadian (+4.9%), and U.S. equities (+4.8%) is set to continue, while EAFE stocks should lag. In fact, this is precisely what our relative momentum model also suggests (**Chart 17**).

17 Geographic leadership is at a crossroads



CIO Office (data via Refinitiv)

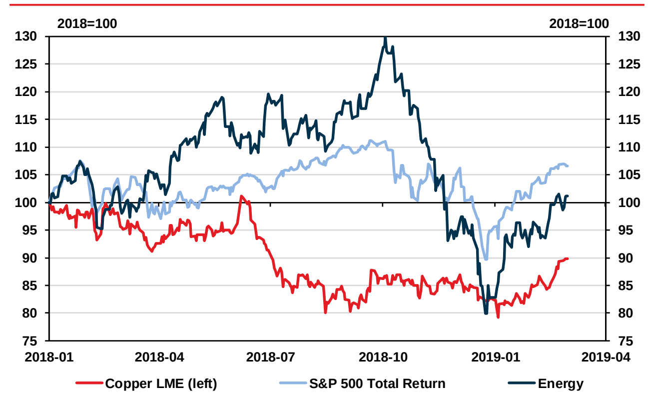
Under these circumstances, we remain comfortable with our geographical allocation (a slight overweight in Canadian and emerging markets, underweight EAFE, and neutral U.S. stance), and stand by ready to increase our deviations should clearer trends emerge.

Commodities: The Doctor and His Wild Unstable Brother

There's a saying in commodity markets: "copper has a Ph.D in economics." The metal's presence in all major industries (such as housing, electronics, and power transmission) makes it a natural barometer for the global health of the economy and has proven timely in projecting some turning points in growth trends.

In retrospect, we should have listened to Doctor Copper's advice last year. Contrary to crude oil, the metal started weakening in July – about three months before the risk-off event at the end of 2018 (**Chart 18**). The message is a much more positive one today, as the 10.2% rally since the start of the year seems to confirm our assessment that most of the bad news now lies behind us.

18 We should have listened to Dr. Copper last July

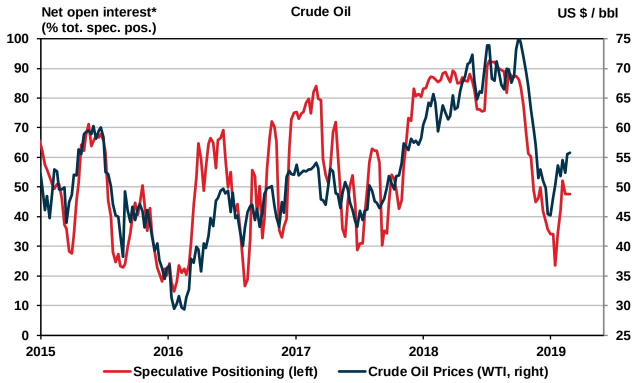


CIO Office (data via Refinitiv)

Meanwhile, crude oil continues to play the role of the Doctor's wild and unstable brother, losing close to 40% in Q4-2018 and then rallying 29% from its lows since. At first glance, blaming speculative forces is tempting (**Chart 19**, next page), but these only tell one part of the story. The fact of the matter is the product is still falling victim to a tug-of-war between OPEC output and U.S. shale oil activity blended with views on future demand.

On the bullish side, Saudi Arabia is very motivated in supporting prices (no matter what President Trump says) by providing for its production to be 500 thousand barrels per day (b/d) lower than what was agreed upon in the OPEC+Russia agreement. This decision was made to offset Russia's incapacity to cut as much as promised. Additionally, the Venezuelan situation continues to

19 Speculation certainly played a role in price movements

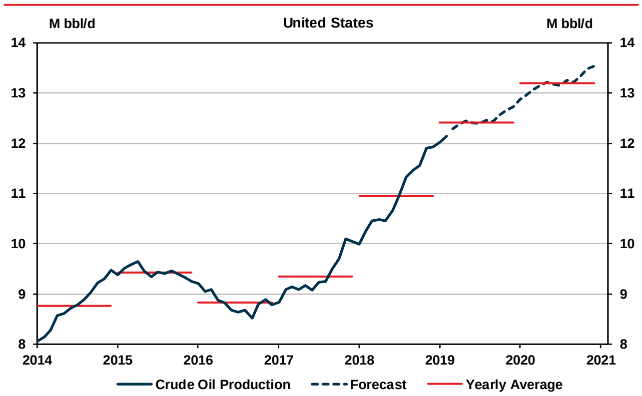


CIO Office (data via Refinitiv)
*Net open interest is calculated as long less short money managers' open contracts divided by the sum of the two.

deteriorate and further U.S. sanctions on the country's oil industry is adding pressure to production activity.

On the bearish side, U.S. production continues its march upward, with the U.S. Energy Information Administration forecasting the country will increase its production by 1.45 million b/d in 2019, close to 900 thousand b/d higher than the same projection made a year ago (**Chart 20**). This rise in production is not surprising, as most of the activity in the Permian Basin will benefit from new pipelines which should debottleneck export constraints and improve margins in the second half of the year.

20 U.S. production growth remains impressive



CIO Office (data via Refinitiv, forecasts from the Energy Information Agency)

But, at the end of the day, the key factor that should drive prices over the next few months will be demand robustness – i.e. the general state of the global economy – which, again, we expect to remain supportive.

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