NATIONAL BANK INVESTMENTS

ASSET ALLOCATION STRATEGY

November 2019

Make or Break?

Highlights

- Investors' emotions were once again put to the test last month. This time, however, trade tensions were not the cause of the pull-back but rather a catalyst for the rebound, with Chinese and U.S. negotiators securing a respite and seemingly working toward a so-called "phase one" deal. The main culprit behind early October market jitters was the decline of the ISM Purchasing Manager Index (PMI) — a key survey of the U.S. manufacturing sector activity — to its lowest level since June 2009.
- The key question is: Now what? Has the ISM PMI bottomed out or is this the onset of a sustained decline? In order to recognize the implications of these two contingencies, we looked at what history suggests for the next 12 months should we either follow the average pattern of a sustained rebound in the ISM PMI or that of a first dip ahead of a recession.
- Implications for the stock market could not be more clear-cut, with an ~20% average upside should growth pick up, and ~20% downside in the event of a recession. As for U.S. 10-year rates, they undoubtedly have upside should growth resume, but it seems limited. On the other hand, a recession would see U.S. 10-year Treasury yields fall near the 1% mark, still shy of the negative territory.
- To be clear, average historical patterns only give a broad idea of what one should expect, whereas all periods have their own set of surprises and peculiarities. One thing is certain, however: we are nearing the "make or break" moment for the global economy, largely dependent on the ability of the U.S. and Chinese administrations to find some common ground. The good news is that both sides seem to have grasped what is at stake, working on an interim agreement that may or may not be ready for signature by the end of November, but is likely to inhibit the two nations from enforcing their most damaging protectionist threats.
- Bottom line? The combination of a de-escalation of trade tensions and largely accommodative monetary policies increases the odds of a cyclical rebound in economic activity over the next year. This should lead equities to outperform bonds, although the current level of valuations and earnings suggest that single-digit returns are to be expected. Under these circumstances, we have sold a fraction of our bond allocation in favour of equities in October - a first move back into cyclical assets.
- Our overall positioning remains rather cautious for now, however, having also increased our allocation to cash. Why? First, because the exact timing of the bottom in growth and the actual content of a prospective U.S./China "phase one" deal remain uncertain. But also, because the risk-reward characteristics of bonds are not as compelling as they were earlier this year.
- Geographically, we have scaled back our Canadian equities position and added to the EAFE region, in line with our relative momentum model recommendations. Beyond price action, the S&P/TSX propensity to better absorb shocks in times of trade tension is, in our view, not as much of a necessity now. As for EAFE equities, weaker growth prospects and uncertainty around Trump's decision on auto tariffs continue to weigh on the region. But, there is upside should global growth pick up.
- Finally, the Canadian dollar's recent rally inclined us to take some profits on our overweight position, but we expect to resume this stance once the economic/geopolitical agenda clears up.

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

> The Federal Reserve cut its policy rate once more in late October signalling this might be the last one for some time, while the Bank of Canada elected to remain on the sidelines.

> Last month also saw the U.S. yield curve steepening, with the 10-year less three-month benchmark rates back in positive territory for the first time since May.

> Yields also rose over the period, as economic and geopolitical risk factors (i.e. the U.S.-China trade war) seemed to be moderating.

Canadian Equities

> Unable to recover from a poor start to the month, Canadian equities lagged behind most other indices in October.

> Consumer staples and energy stocks were the main culprits behind this underperformance, as earnings season has been relatively unkind to these sectors up to now, when compared to their counterparts south of the border.

U.S. Equities

> Meanwhile, in the U.S., the S&P 500 closed out the month breaking through to an all-time record.

> Weakness in the ISM Manufacturing PMI at the start of the month was soon a distant memory as positive earnings surprises took centre stage.

> Of note, FAANG + Microsoft stocks – which together make up 18% of the Index – rose 5.4% in October, contributing greatly to reaching its record high.

> More broadly speaking, nearly three-quarters of all firms that reported in October provided an earnings beat.

Commodities

> October was a month of subdued volatility in the oil market, with the WTI trading in a narrow band to finish the period flat.

> A risk-on mood following news that a "phase one" deal between the U.S. and China could soon be reached failed to translate into stronger oil prices, as U.S. crude stockpiles soared late in the month, putting downward pressure on the commodity.

> Meanwhile, the spread between Canadian crude and its American counterpart grew larger still, as transportation issues continue to plague the country's largest industry.

Foreign Exchange

> The U.S. Dollar index began October at its highest level since May 2017, but finished the period near a two-month low following positive Sino-American trade-related developments.

> As for the Loonie, a surprisingly strong labour market helped it appreciate to a three-month high by late October, only to see most of its gains erased by a more-dovish-than-expected Bank of Canada Monetary Policy report published just days later.

Table 2 Market Total Returns

Asset Classes	October	YTD	12 months
Cash (3-month T-bills)	0.1%	1.4%	1.7%
Bonds (FTSE/TMX Ovr. Univ.)	**-0.2%**	**7.6%**	**10.2%**
FTSE/TMX Short term	0.2%	3.2%	4.7%
FTSE/TMX Mid term	-0.1%	6.8%	9.8%
FTSE/TMX Long term	-0.7%	14.1%	18.0%
FTSE/TMX Government	-0.2%	7.5%	10.4%
Federal	-0.1%	4.8%	7.8%
Provincial	-0.4%	10.1%	13.0%
Municipal	-0.2%	9.7%	12.3%
FTSE/TMX Corporate	0.0%	7.9%	9.5%
AA+	0.2%	4.7%	6.3%
A	-0.2%	9.7%	11.7%
BBB	-0.1%	8.7%	10.0%
BoAML High-Yield (USD)	0.2%	11.8%	8.3%
Preferred Shares	0.2%	-0.2%	-7.7%
Canadian Equities (S&P/TSX)	**-0.9%**	**18.1%**	**13.2%**
Energy	-4.3%	8.8%	-1.0%
Industrials	0.9%	20.4%	10.8%
Financials	0.4%	20.7%	14.3%
Materials	2.9%	18.2%	25.1%
Utilities	-1.0%	33.5%	35.3%
Cons. Disc	-4.2%	13.1%	6.5%
Cons. Staples	-4.5%	13.7%	21.1%
Healthcare	-4.5%	-9.6%	-29.0%
IT	-1.1%	47.2%	43.7%
Comm. Svc.	-1.5%	10.3%	14.8%
REITs	-2.4%	22.6%	18.0%
S&P/TSX Small Cap	-1.9%	7.0%	-0.8%
US Equities (S&P500 USD)	**2.2%**	**23.2%**	**14.3%**
Energy	-2.3%	3.6%	-11.0%
Industrials	1.1%	23.9%	14.9%
Financials	2.4%	22.5%	11.7%
Materials	0.0%	17.2%	13.5%
Utilities	-0.8%	24.4%	23.7%
Cons. Disc	0.3%	22.9%	15.8%
Cons. Staples	-0.1%	23.1%	14.0%
Healthcare	5.1%	11.0%	8.6%
IT	3.9%	36.5%	22.6%
Comm. Svc.	3.0%	25.4%	15.5%
REITs	-0.1%	29.6%	26.7%
Russell 2000 (USD)	2.6%	15.9%	3.4%
World Eq. (MSCI ACWI)	**2.8%**	**19.9%**	**13.2%**
MSCI EAFE (USD)	3.6%	17.4%	11.6%
MSCI EM (USD)	4.2%	10.7%	12.3%
Commodities (CRB index)	**0.5%**	**-4.8%**	**-6.3%**
WTI Oil (US$/barrel)	-0.2%	19.4%	-17.3%
Gold (US$/ounce)	2.5%	17.9%	24.2%
Copper (US$/tonne)	1.3%	-3.0%	-4.4%
Forex (DXY - US Dollar index)	**-2.0%**	**1.2%**	**0.2%**
USD per EUR	2.3%	-2.4%	-1.5%
CAD per USD	-0.6%	-3.5%	0.0%

CIO Office (data via Refinitiv) 10/31/2019

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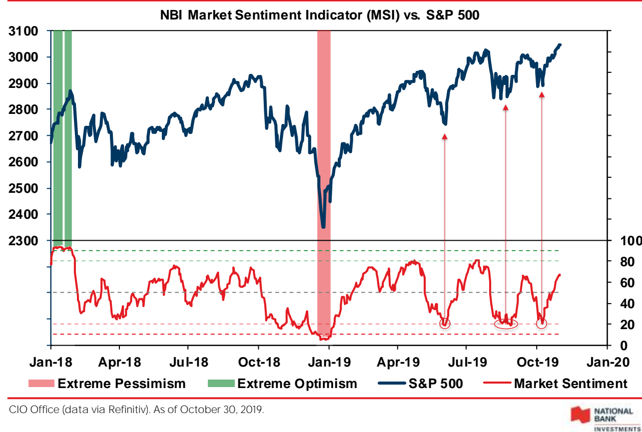
Make or Break?

Investors' emotions were once again put to the test last month, with our market sentiment indicator bouncing spot-on the pessimism threshold (20) for a third time this year (Chart 1). This time, however, trade tensions were not the cause of the pull-back, but rather a catalyst for the rebound, with Chinese and U.S. negotiators securing a respite and seemingly working towards a so-called "phase one" deal expected to be signed in the coming weeks.

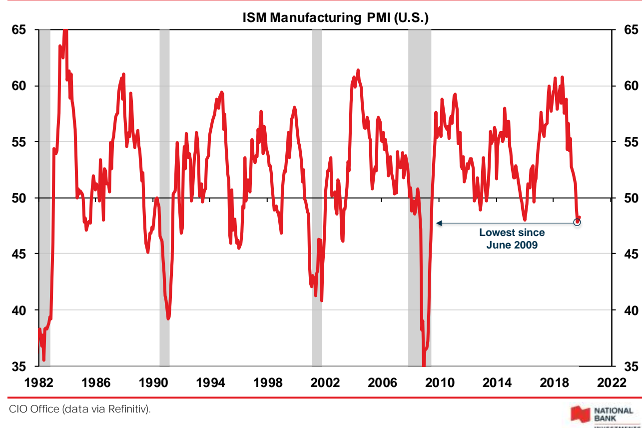
1 Third test for market sentiment in October…



CIO Office (data via Refinitiv). As of October 30, 2019.

The main culprit behind early October market jitters was the decline of the ISM Purchasing Manager Index (PMI) – a key survey of the U.S. manufacturing sector activity – to its lowest level since June 2009 (Chart 2).

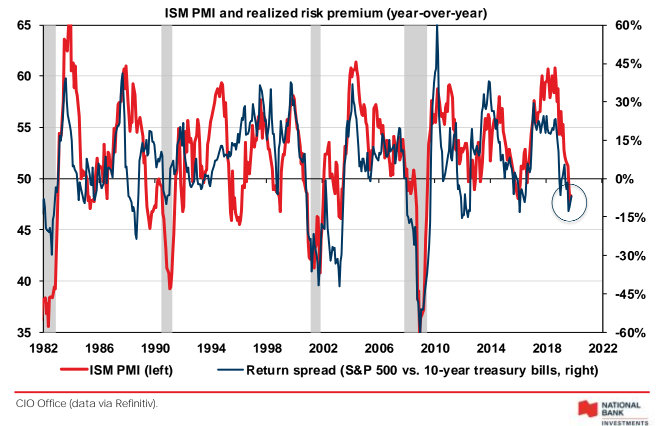
2 … following a steep decline in manufacturing activity…



CIO Office (data via Refinitiv).

At first glance, investors' reactions were understandable, as the ISM PMI has been an accurate bellwether for the business cycle for many decades now. But as asset allocators, our first response was instead to compare this indicator to the realized equity risk premium to see if there was any disconnect between the message sent by the manufacturing sector and what financial markets were already pricing in. Our conclusion: the October ISM plunge looked more like a confirmation of what markets had already been discounting for some time now, with safer U.S. government bonds (+16.8 % year-over-year as of the end of September) well ahead of riskier U.S. equities (+3.7%) (Chart 3).

3 … yet already well discounted by financial assets



CIO Office (data via Refinitiv).

The key question is: Now what? Has the ISM PMI bottomed out or is this the onset of a sustained decline that could result in a recession? Of course, today's (November 1) slight increase in the ISM PMI (from 47.8 to 48.3) is a step in the right direction, but it remains uncertain whether this trend will stand the test of time.

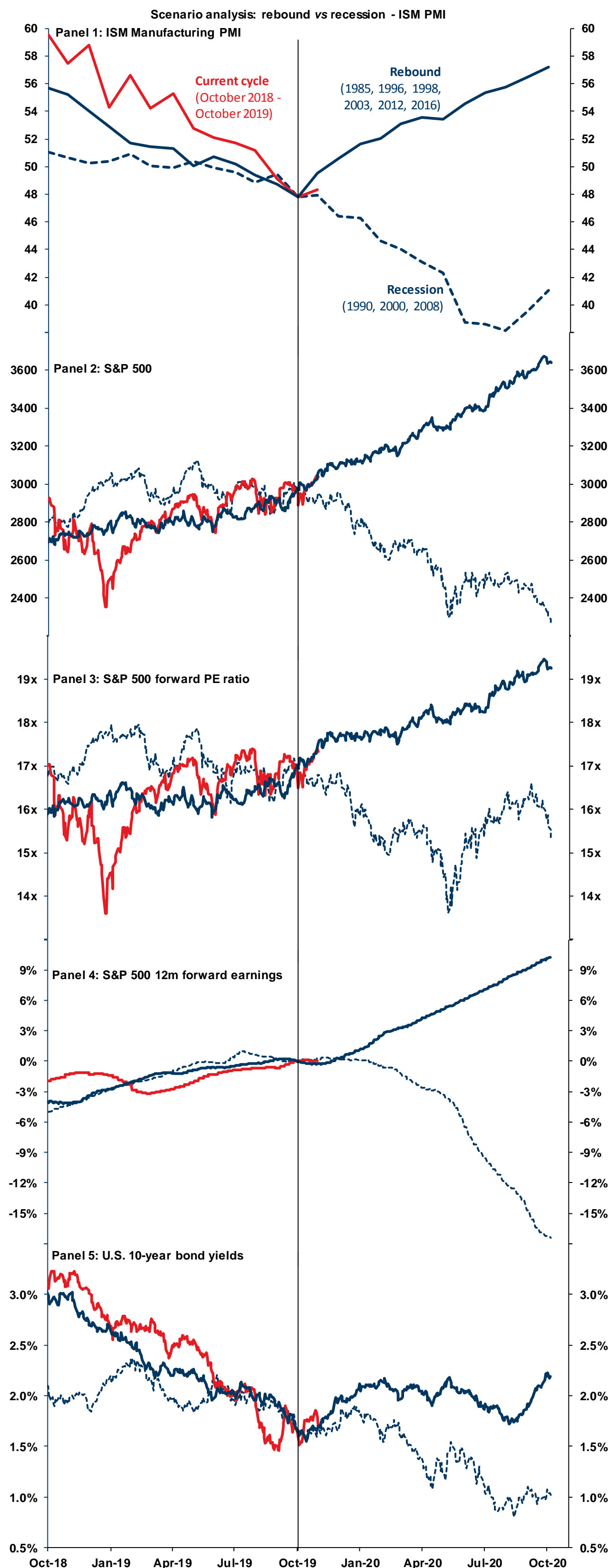
First, let's evaluate what the implications would be of these two contingencies. To do so, we have normalized U.S. equities and 10-year bond yields at their end of September levels, and looked at what history suggests for the next 12 months should we either follow the average pattern of a sustained rebound in the ISM PMI (1985, 1996, 1998, 2003, 2012, and 2016) or that of a first dip ahead of a recession (1990, 2000, and 2008) (Chart 4, next page).

Implications for the stock market could not be more clear-cut, with an ~20% average upside should growth pick up, and ~20% downside in the event of a recession. Interestingly, the more pessimistic scenario would bring the S&P 500 back near last December's trough, demonstrating that the Q4-2018 market correction was on the magnitude of what we typically see in times of recession (Chart 4, Panel 2, next page).

To better evaluate the possibility of such equity returns in the current context, we also detailed the proportion of S&P 500 changes that is historically attributable to ratio expansion/contraction and earnings growth/drop. With respect to valuations, the average PMI rebound saw the forward price/earnings ratio increase by ~2x which, applied to the current context, would bring valuations near a 20-year high. While that is not impossible, we must recognize that it seems difficult to envisage at this point (Chart 4, Panel 3, next page).

For their part, forward earnings have increased by ~10% on average in times of manufacturing upturns, a plausible scenario that will, however, require genuine positive results from corporate America rather than the "not as bad as expected" that characterized much of the last few earnings seasons (Chart 4, Panel 4, next page).

4 Rebound or recession? That is the question



CIO Office (data via Refinitiv). All figures are as of their September 30 level. Rebound = average change from a trough when the ISM PMI dipped below 50, withouth leading to a recession. Recession = average path from a first ISM PMI dip below 50 when a U.S. Recession followed in subsequent months.

Finally, performing the same analysis on U.S. 10-year rates revealed two interesting points. First, bond yields undoubtably have upside should growth resume, but it seems limited (~+50 bps to a maximum of 2.25% over the next twelve months) if we are to believe the six instances of PMI rebounds since 1985. On the other hand, a recession would see U.S. 10-year Treasury yields fall to near the 1% mark, a level never seen before but still shy of negative territory (Chart 4, Panel 5).

To be clear, average historical patterns only give a broad idea of what one should expect, whereas all periods have their own set of surprises and peculiarities. One thing is certain however: we are nearing the "make or break" moment for the global economy, largely dependent on the ability of the U.S. and Chinese administrations to find some common ground on the trade war front. The good news is that both sides seem to have grasped what is at stake, working on an interim agreement that may or may not be ready for signature by the end of November, but is likely to inhibit the two nations from enforcing their most damaging protectionist threats.

Bottom line? The combination of a de-escalation of trade tensions and largely accommodative monetary policies increases the odds of a cyclical rebound in economic activity over the next year. This should lead equities to outperform bonds, although the current level of valuations and earnings suggest that single-digit returns are to be expected.

Under these circumstances, we have sold a fraction of our bond allocation in favour of equities in October – a first move back into cyclical assets. Our overall positioning remains rather cautious for now, however, having also increased our allocation to cash. Why? First, because the exact timing of the bottom in growth and the actual content of a prospective U.S./China "phase one" deal remain uncertain. But also, because the risk-reward characteristics of bonds are not as compelling as they were earlier this year, as we detail in the following section.

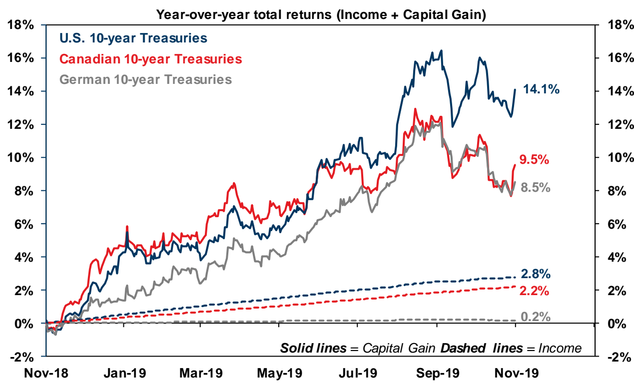
Fixed Income: Balancing Risk with Reward

The last twelve months have been remarkable for most fixed-income assets. But, the "fixed income" component actually had, in most cases, little to do with this outcome. Indeed, capital gains are the main driver this year, responsible for 81%, 84%, and 98% of Canadian, U.S., and German 10-year Treasuries year-over-year total returns, respectively (Chart 5, next page).

If we expand on U.S. 10-year Treasuries – the reference point for a majority of bonds around the world – it can be seen that such capital gains are a rather rare event, having only occurred ~2% of the time since 1989, while the year-over-year price return realized as of October 3 was almost unprecedented (Chart 6, next page).

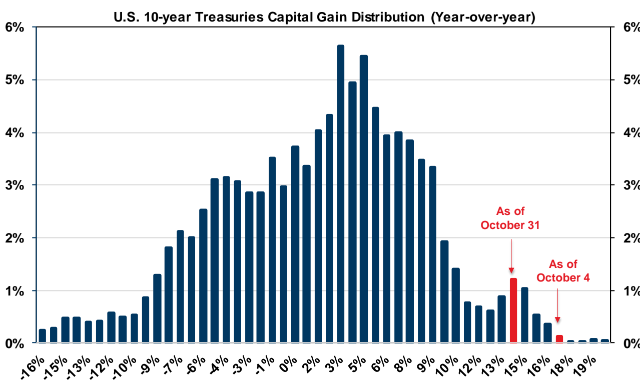
As a result, yield curves have significantly flattened globally. That holds especially true on our side of the border, where investors can now expect a similar yield-to-maturity for holding government securities with terms ranging from 3-months all the way up to 30-years (Chart 7, next page). This means that the trade-off between holding cash or longer-term bonds isn't so much a question of yield differentials, but whether we believe there is room for even more capital appreciation (i.e. lower long-term yields).

5 Little income but large gains for… fixed income assets



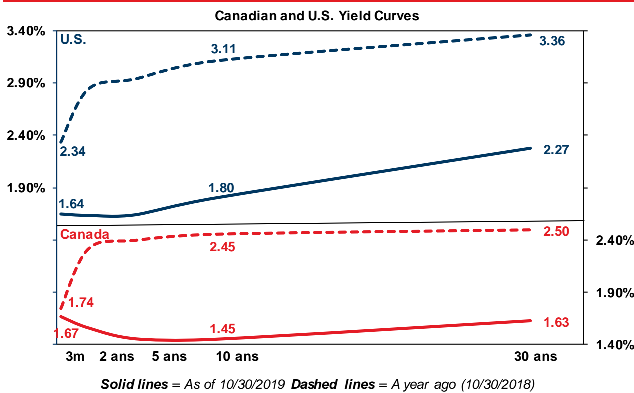
CIO Office (data via Refinitiv).

6 Such capital gains are a rather rare event



CIO Office (data via Refinitiv). Data since 1989.

7 Lower and flatter for most yield curves

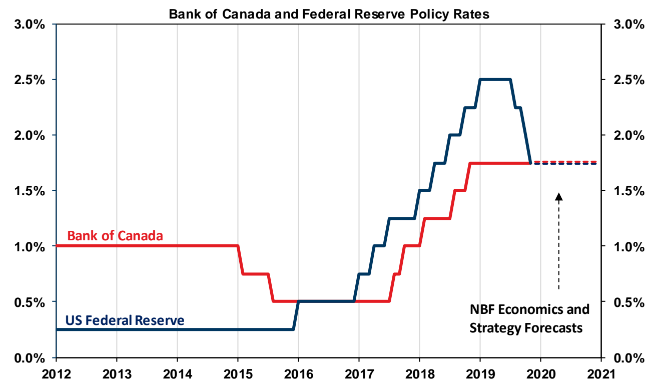


CIO Office (data via Refinitiv).

Statistically speaking, two consecutive years with outcomes that "normally" happen no more than 2% of the time is hard to imagine. Realistically speaking, we believe that this would only be possible in the event of a more serious economic downturn and subsequent monetary easing – not something that we currently foresee.

That said, it doesn't mean that bond yields are set to skyrocket. With regard to the potential impact of central banks, the Federal Reserve made it clear that it doesn't intend to hike its policy rate any time soon, having just completed a series of three "preventive" rate cuts, a playbook that served it well in 1995 and 1998. In Canada, Governor Poloz should also remain on the sidelines in the coming months, unlikely to elect for rate hikes, especially in light of his more dovish tone during the October 30 Bank of Canada post-meeting press conference (Chart 8).

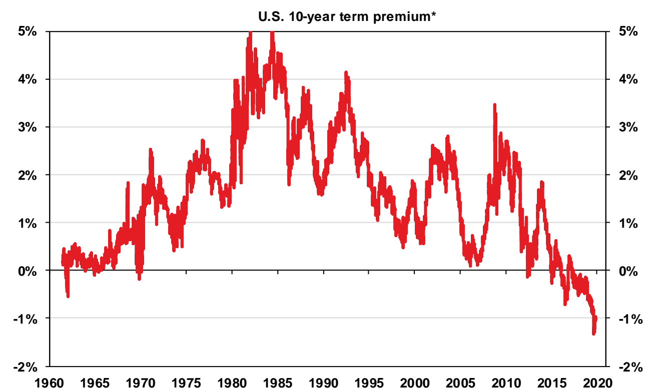
8 Extended break for central banks?



CIO Office (data via Refinitiv, NBF Economics & Strategy).

Yet, there is one wild card: the term premium, which remains close to an historic low in negative territory (Chart 9). There are several factors explaining this economic anomaly – as we discussed in our September monthly report – but it's clear that a pick-up in investor sentiment could reverse this trend.

9 The term premium is a wild card



CIO Office (data via Refinitiv). *New York Fed economists Tobias Adrian, Richard Crump, and Emanuel Moench (or "ACM") Treasury term premia estimates

In short, with (1) rising odds of a cyclical rebound in economic activity, (2) substantial gains made on the backs of the central banks' policy turnaround over this past year, and (3) longer-term yields now roughly equal to the cash rate, bonds seem more at risk of lagging over the next few months.

Equities: Inflection Point

October turned out positively for most equity indices – which continue to expand their solid year-to-date returns. The

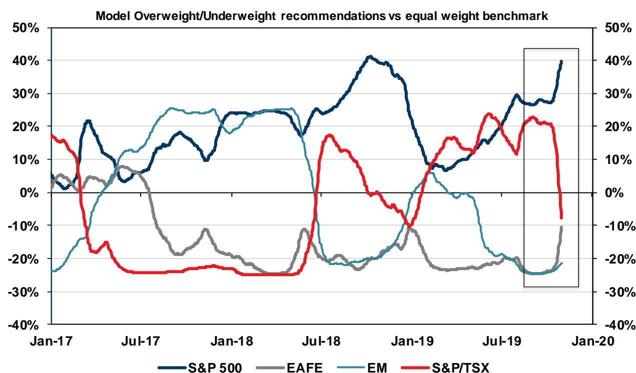
exception was the S&P/TSX, hampered by considerable declines in the energy sector (Chart 10).

10 October turned out positively for all but Canada…

CIO Office (data via Refinitiv).

These trends were mirrored in our relative momentum model recommendations, inclining us to scale back our Canadian equities position and add to the EAFE region (Chart 11).

11 … as unmistakably mirrored by our relative model



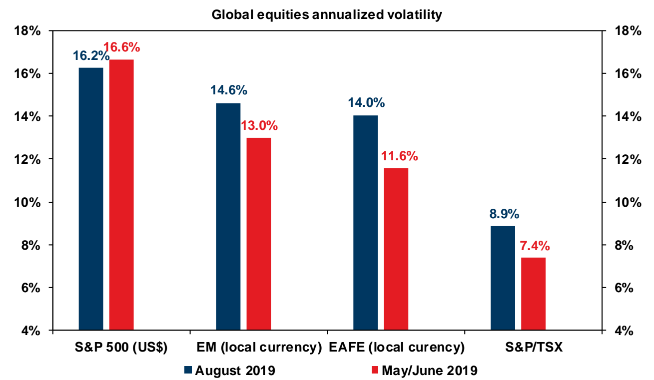
CIO Office (data via Refinitiv).

Beyond price action, the S&P/TSX's propensity to better absorb shocks in times of escalating trade tension – as it did back in May/June and August 2019 (Chart 12) – is not, in our view, as much of a necessity now.

As for EAFE equities, weaker growth prospects and uncertainty around Trump's decision on auto tariffs (the deadline is November 13) continue to weigh on the region. But, there is upside should global growth pick up. Case in point: if we return to our analysis of the implications of a rebound in manufacturing activity presented in the introduction, we see that it is international equities that tend to outperform in periods of cyclical upturns (Chart 13).

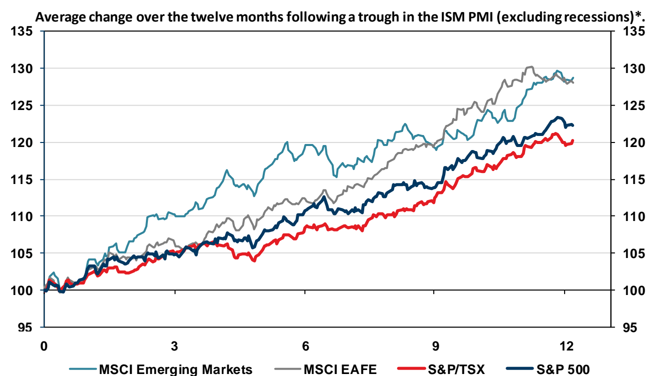
Much uncertainty remains as we are seemingly approaching an inflection point for the global economy, and we will keep a close eye on forward earnings estimates to confirm whether we are heading for better or for worse (Chart 14).

12 S&P/TSX lower volatility not as much of a necessity now



CIO Office (data via Refinitiv).

13 EM/EAFE tend to outperform in periods of cyclical upturns



CIO Office (data via Refinitiv). *May 1985/1986, Jan. 1996/1997, Dec. 1998/1999, April 2003/2004, Nov. 2012/2013, Jan. 2016/2017

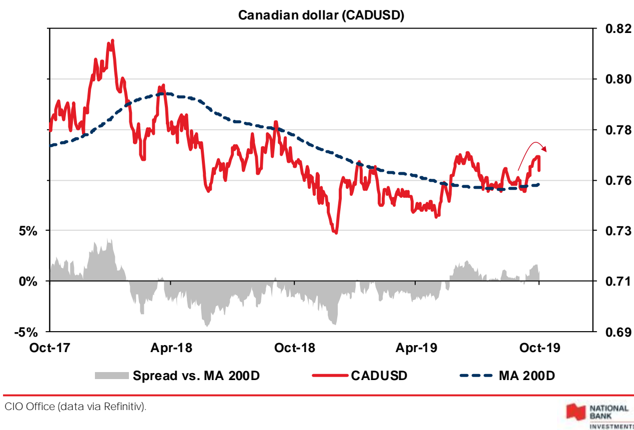
14 An inflection point is seemingly on the horizon

CIO Office (data via Refinitiv).

Currencies: Timely Moves

The slow and steady decline of the Loonie over the third quarter of 2019 suddenly ended last month, as surprisingly strong Canadian labour market data – employment rising 43k above the consensus estimate – helped reverse this trend. By October 28, and amid this risk-on mood, the currency had attained a 3-month high (Chart 15, next page).

15 Short flight for the Loonie in october…

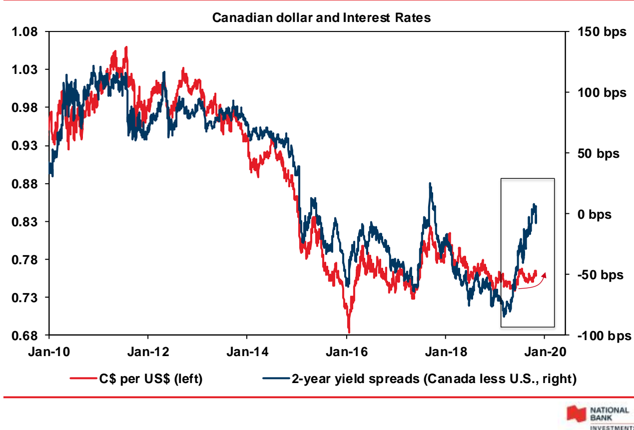


CIO Office (data via Refinitiv).

The most recent change to our asset allocation involved a shift from Canadian dollar denominated, fixed-income assets to U.S. dollar denominated equities. Given the Loonie's recent rally, we thought it an opportune moment to take some profits on our Canadian dollar overweight position… which we did, just in time before a surprisingly dovish Bank of Canada sent the currency back down.

Given that the evolution of interest rate differentials between our two countries suggests further upside for the Loonie (Chart 16), we expect to return to an overweight CAD position in the near future. However, before making our move, we will want to wait and see how the geopolitical and economic backdrops evolve and, more specifically, how broad the "phase one" deal between China and the U.S. will turn out to be.

16 … but rate differentials suggest further upside ahead



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General

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