NATIONAL BANK INVESTMENTS

ASSET ALLOCATION STRATEGY

October 2019

A Changing Climate

Highlights

- It was a rather eventful third quarter that came to an end last month, with investor sentiment toward the climate between China and the U.S. swaying from optimism to pessimism, and now back to optimism. Despite this rapidly changing environment, a plain-vanilla, balanced portfolio has managed to generate a solid 12% total return so far this year, on track as the best annual performance since 2013.
- The launch of an official impeachment inquiry against the U.S. President announced in late September does not bode well for any hope of political or social cohesion south of the border. But with regard to any potential impact for financial markets, let us recall that the last two occurrences of such procedures did not materially change the already-established trend in stock markets—one up and the other down—hence why our focus should remain on more pressing economic events.
- The important development for global markets last month was rather on the monetary policy front, with central banks' shift to an accommodative stance and the subsequent equity market's response increasingly reminiscent of the late 1990s. Indeed, actions taken by several central banks back then—including three rate cuts by the Federal Reserve between September and November of 1998—ultimately led to a rebound in economic activity over the following two years, proving wrong the warning signals from the yield curve inversion of 1998. That said, it is by no means certain that monetary policy alone will do the work this time around, especially given the challenges of trade policy uncertainty.
- Bottom line? Odds of a cyclical rebound in economic activity are increasing—courtesy of accommodative monetary policies—but a lack of conclusive announcements on the trade front translates into non-negligible short-term downside risks. Under these circumstances, we chose not to alter our asset allocation for now as we await (1) a confirmation of lasting improvements in key economic figures, (2) a signal from our market sentiment indicator and/or (3) clarity on the trade front.
- With global bond yields bouncing back in September, Canadian preferred shares regained some ground. The path forward is a tough call, but it should be underlined that the valuation spread between government bonds and preferred shares recently reached a level which increasingly favours the latter, if only because of mean reversion.
- Events in Saudi Arabia raised questions over the risk that the world economy could be choked by a rapid and sustained rise in crude oil prices. Yet, there are two fundamental changes that mitigate the risk of a disruptive oil shock: the decline in the global economy's dependence on oil and the rise of U.S. production.
- The ups and downs of Brexit have been plentiful since June 2016, but it seems that a turning point in this chaotic story is about to unfold. And, judging by the significant short Pound positioning by speculators, this could lead to wild swings for the currency.
- Our basic thesis as we initiated our North American overweight was that the Canadian market's lower volatility and lower valuation made it an attractive alternative in the current tense context, while the more volatile U.S. stocks would ultimately benefit from a resilient economy and flexible Central Bank. In contrast, growth in Europe and emerging markets seemed more likely to suffer in an environment where global trade was under pressure. This proved accurate and still holds.

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			■		

CIO Office

Current Allocation ■

Previous Allocation

Market Review

Fixed Income

- Both the ECB and the Fed lowered their respective policy rates in September, amid a climate of decelerating global growth and important geopolitical uncertainty.
- Fixed-income products fared poorly in this environment though, as longer-term yields finished the month up from their August lows.
- It was Canadian preferred shares that closed out the period as the best performing major asset class, allowing them to recoup losses from earlier months and finish the quarter flat.

Canadian Equities

- September was something of a mixed month for Canadian equities, with about as many sectors gaining over the period as there were that lost some ground.
- The Utilities sector reached its 9th consecutive month of positive returns–a record going back at least to 1988–as investors continued to prize defensive stocks amidst the current volatile geopolitical landscape.
- After Information Technology price multiples reached historic highs yet again last month, the sector finally gave back some of its impressive year-to-date gains to finish the period near the bottom of the barrel.

U.S. Equities

- With both high-level trade talks between China and the U.S. and its latest earnings season set to begin in October, American stocks remained relatively quiet last month, rising just enough to finish the quarter on a positive note.
- It comes as little surprise then that the U.S. Utilities sector–often sought out as a more defensive equity alternative in times of uncertainty–finished near the top of the pack (up 4.3%) over this same period.

Commodities

- September saw the largest single-day spike in WTI prices since December 2008 following a drone attack on Saudi Arabian oil infrastructure.
- Prices were quick to return to previous levels though as the supply disruption was relatively short-lived and finished the month trading at 54.07$/bbl, just 1$ down from where they stood at the end of August.

Foreign Exchange

- The Loonie finished the month relatively flat, never breaking out of its tight September trading range, even as the Bank of Canada remained on the sidelines at a time when most other major central banks allowed for monetary easing.
- Across the pond, Brexit turmoil continued to weigh on the British pound, with sterling finishing the quarter 3% cheaper against the U.S. dollar.
- On the other hand, the greenback continued to strengthen–despite the FOMC's rate cut in mid September–and closed out Q3 2019 at its highest level since May 2017.

Table 2 Market Total Returns

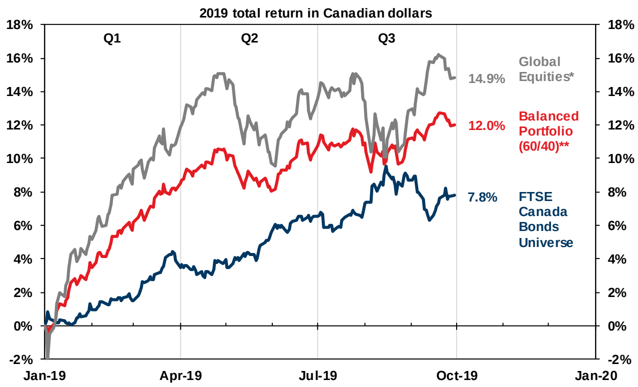
Asset Classes	September	Q3	YTD
Cash (3-month T-bills)	0.1%	0.4%	1.2%
Bonds (FTSE/TMX Ovr. Univ.)	**-0.8%**	**1.2%**	**7.8%**
FTSE/TMX Short term	-0.4%	0.3%	3.0%
FTSE/TMX Mid term	-1.1%	0.9%	6.9%
FTSE/TMX Long term	-1.3%	2.5%	14.9%
FTSE/TMX Government	-1.0%	1.2%	7.7%
Federal	-0.9%	0.8%	4.9%
Provincial	-1.0%	1.6%	10.5%
Municipal	-0.9%	1.6%	9.9%
FTSE/TMX Corporate	-0.5%	1.1%	8.0%
AA+	-0.4%	0.4%	4.5%
A	-0.7%	1.5%	9.9%
BBB	-0.5%	1.2%	8.8%
BoAML High-Yield (USD)	0.3%	1.3%	11.5%
Preferred Shares	3.3%	0.5%	-0.4%
Canadian Equities (S&P/TSX)	**1.7%**	**2.5%**	**19.1%**
Energy	5.6%	1.2%	13.6%
Industrials	-2.1%	-1.5%	19.4%
Financials	6.8%	5.2%	20.2%
Materials	-7.3%	0.4%	14.9%
Utilities	3.3%	10.1%	34.8%
Cons. Disc	-1.1%	2.7%	18.1%
Cons. Staples	-0.2%	5.8%	19.0%
Healthcare	-7.3%	-30.0%	-5.4%
IT	-7.1%	3.4%	48.8%
Comm. Svc.	1.1%	2.0%	11.9%
REITs	3.1%	8.5%	25.7%
S&P/TSX Small Cap	-2.8%	-1.2%	9.1%
US Equities (S&P500 USD)	**1.9%**	**1.7%**	**20.6%**
Energy	3.8%	-6.3%	6.0%
Industrials	3.0%	1.0%	22.6%
Financials	4.6%	2.0%	19.6%
Materials	3.2%	-0.1%	17.1%
Utilities	4.3%	9.3%	25.4%
Cons. Disc	0.9%	0.5%	22.5%
Cons. Staples	1.7%	6.1%	23.3%
Healthcare	-0.2%	-2.2%	5.6%
IT	1.5%	3.3%	31.4%
Comm. Svc.	0.4%	2.2%	21.7%
REITs	1.0%	7.7%	29.7%
Russell 2000 (USD)	1.9%	-2.8%	13.0%
World Eq. (MSCI ACWI)	**2.2%**	**0.1%**	**16.7%**
MSCI EAFE (USD)	2.9%	-1.0%	13.3%
MSCI EM (USD)	1.9%	-4.1%	6.2%
Commodities (CRB index)	**0.1%**	**-5.0%**	**-5.3%**
WTI Oil (US$/barrel)	-1.9%	-7.2%	19.6%
Gold (US$/ounce)	-3.6%	4.4%	15.0%
Copper (US$/tonne)	0.7%	-4.8%	-4.3%
Forex (DXY - US Dollar index)	**0.5%**	**3.4%**	**3.3%**
USD per EUR	-1.0%	-4.3%	-4.6%
CAD per USD	-0.5%	1.1%	-2.9%

CIO Office (data via Refinitiv) 2019-09-30

A Changing Climate

It was a rather eventful third quarter that came to an end last month, with investor sentiment toward the climate between China and the U.S. swaying from optimism to pessimism, and now back to optimism amidst a series of goodwill gestures from both sides, and comments from President Trump that a deal "could happen sooner than you think." Despite this rapidly changing environment, a plain-vanilla, balanced portfolio has managed to generate a solid 12% total return so far this year, on track as the best annual performance since 2013 (Chart 1).

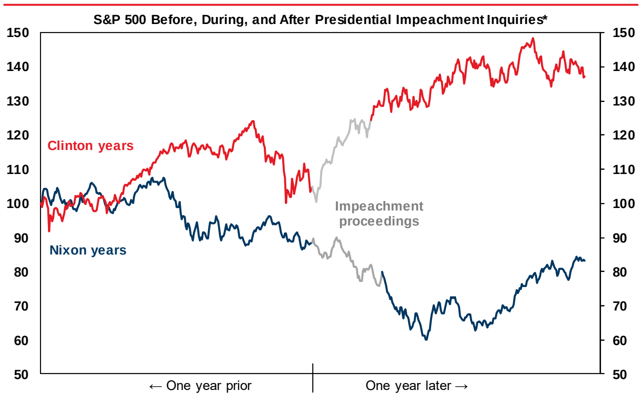
1 Performance is holding up well despite the volatility



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)

Of course, the launch of an official impeachment inquiry against the U.S. President announced in late September does not bode well for any hope of political or social cohesion south of the border, especially in the run-up to the November 2020 election. But with regard to any potential impact for financial markets, let us recall that the last two occurrences of such procedures did not materially change the already-established trend in stock markets—one up and the other down—hence why our focus will remain on more pressing economic events (Chart 2).

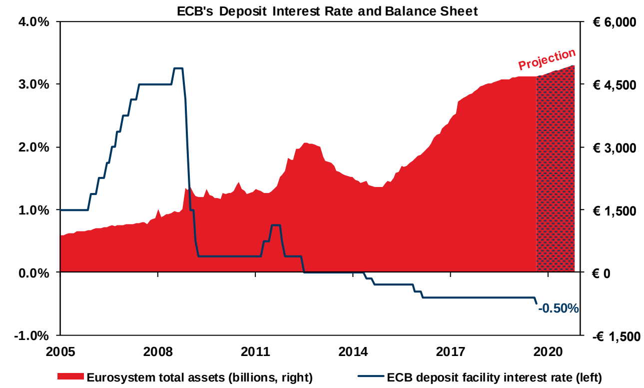
2 Impeachment proceedings shouldn't be a "game changer"



CIO Office (data via Refinitiv). *May 1974 (+/- 1 year) for Nixon, and October 1998 (+/- 1 year) for Clinton.

The important development for global markets last month was rather on the monetary policy front, starting with the European Central Bank's (ECB) decision to cut its already negative deposit rate by 10 basis points and to reboot its quantitative easing program at a pace of €20 billion per month (Chart 3).

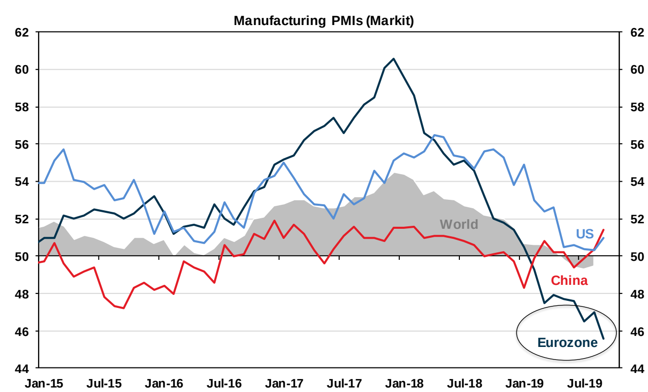
3 Easy monetary policy is the new normal for the ECB...



CIO Office (data via Refinitiv).

In Mario Draghi's own words, these measures are justified by "a more protracted weakness of the Euro-area economy, the persistence of prominent downside risks and muted inflationary pressures" – a situation that should also push "governments with fiscal space (to) act in an effective and timely manner."[1] While this may sound unduly alarmist to some, it must be said that the latest figures from the European manufacturing sector paint an increasingly gloomy picture in the region (Chart 4).

4 ...as the manufacturing sector keeps on retreating



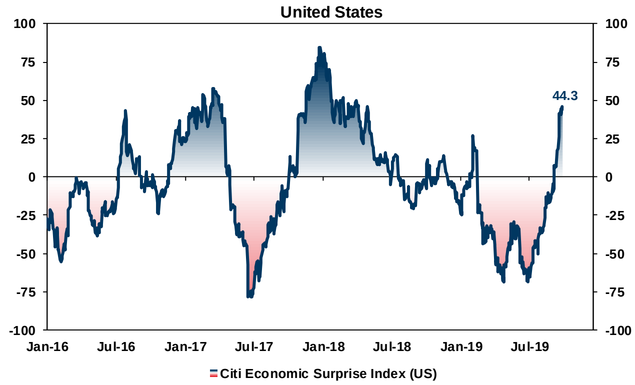
CIO Office (data via Refinitiv). As of September 30, 2019.

Recent economic data were much more encouraging in the United States, as reflected by the surge in the economic surprise index (Chart 5, next page).

Nonetheless, the Federal Reserve moved forward with its second rate cut of the year, citing "muted inflation pressures" and "global developments," i.e., weakening growth in Europe and China, Brexit, and trade policy tensions. Market expectations for further rate cuts softened over the course of September, but it is still widely expected that there should be a third cut by the end of the year (Chart 6, next page).

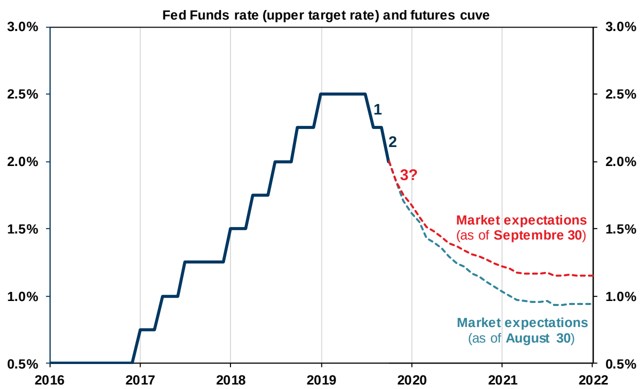
[1] Mario Draghi. September 12, 2019 ECB Press Conference

5 **Good sequence of U.S. economic data in September…**



CIO Office (data via Refinitiv).

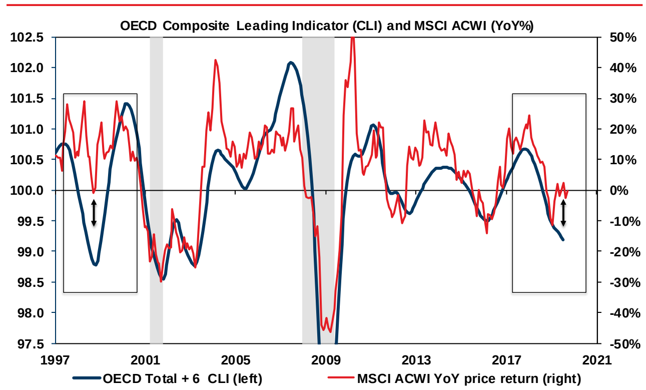
6 … but a third rate cut is still foreseen in 2019



CIO Office (data via Refinitiv).

It is, therefore, against this backdrop of accommodative central banks that global equities managed to hold themselves close to the zero line on a year-over-year basis, despite a substantial slowdown in economic activity. Interestingly, this is reminiscent of the late 1990s when global growth eased similarly without dragging the stock market along with it (Chart 7).

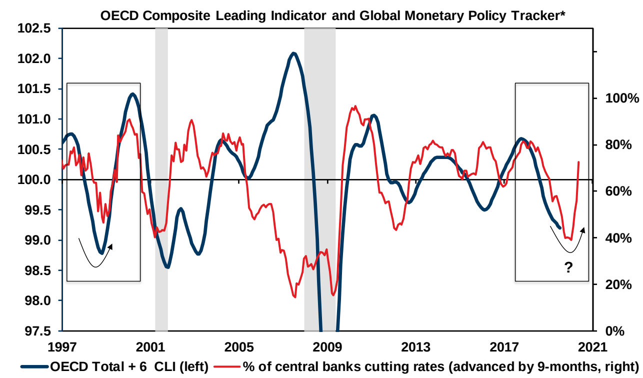
7 It looks increasingly like the late 1990s



CIO Office (data via Refinitiv).

Indeed, actions taken by several central banks back then—including three rate cuts by the Federal Reserve between September and November of 1998—ultimately paved the way for a rebound in economic activity over the following two years, proving wrong the warning signals from the yield curve inversion of 1998. Further to this point, a look at the percentage of central banks in "easing" mode against the OECD's measure of global economic growth does suggest that we might again be set for an upturn in the months to come as was the case in 1999 (Chart 8).

8 Will **central banks' route change do the work this time?**



CIO Office (data via Refinitiv).

That said, it is by no means certain that the central banks' route change alone will do the work this time around. As Chairman Powell said back in August, "while monetary policy is a powerful tool […], it cannot provide a settled rulebook for international trade"[2] in allusion to the challenge of incorporating trade policy uncertainty into the Fed's framework.

So, what can we conclude from all this? That odds of a cyclical rebound in economic activity are increasing—courtesy of accommodative monetary policies—but a lack of conclusive announcements on the trade front translates into non-negligible short-term downside risks. Under these circumstances, we chose not to alter our asset allocation for now as we await (1) a confirmation of lasting improvements in key economic indicators, (2) a signal from our market sentiment indicator and/or (3) clarity on the trade front.

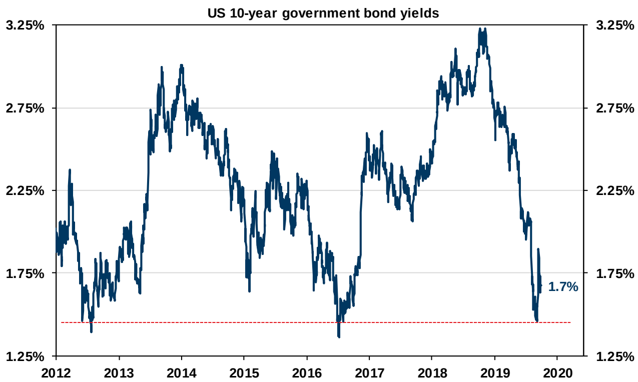
Fixed Income: Mean Reversion is a Force of Nature

Global bond yields bounced back in September, with U.S. 10-year treasuries bumping against their July 2012/July 2016 lows (Chart 9, next page).

In our last monthly report, we mentioned government bond yields were likely to rebound given the magnitude and speed of their descent, if only under the effect of mean reversion. It was finally the recognition in September that estimates on multiple U.S. economic figures were far too pessimistic which sparked a reversal (Chart 10, next page).

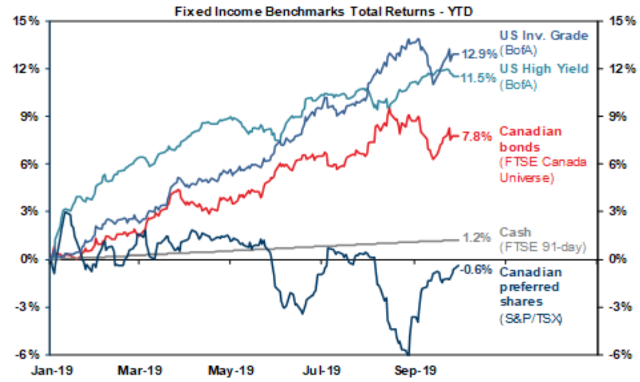
2 Jerome Powell, "Challenges for Monetary Policy" symposium in Jackson Hole, August 23, 2019.

9 **U.S bond yields bounced back in September...**



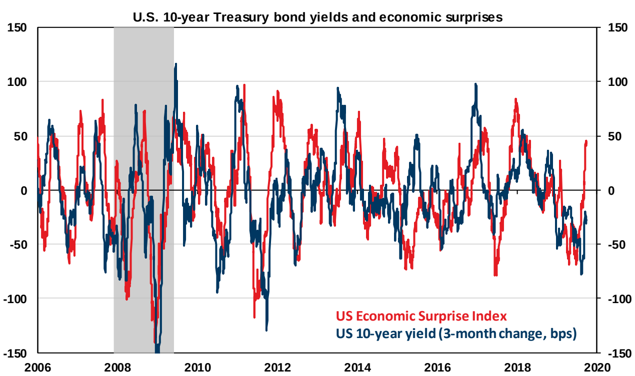
CIO Office (data via Refinitiv).

11 **... but nothing to change the 2019 ranking for fixed income**



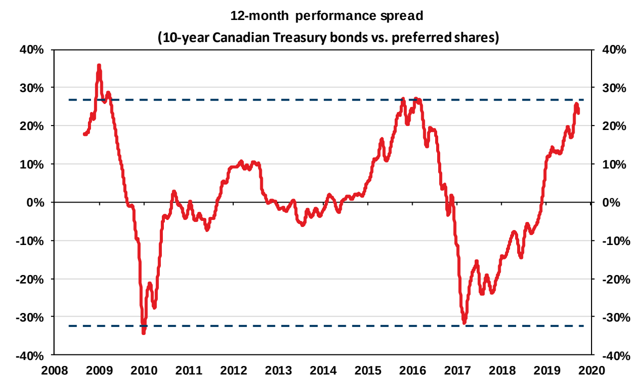
CIO Office (data via Refinitiv).

10 **... lifted by better**-than-**expected economic data...**



CIO Office (data via Refinitiv).

12 Is the worst over for canadian preferred shares?



CIO Office (data via Refinitiv).

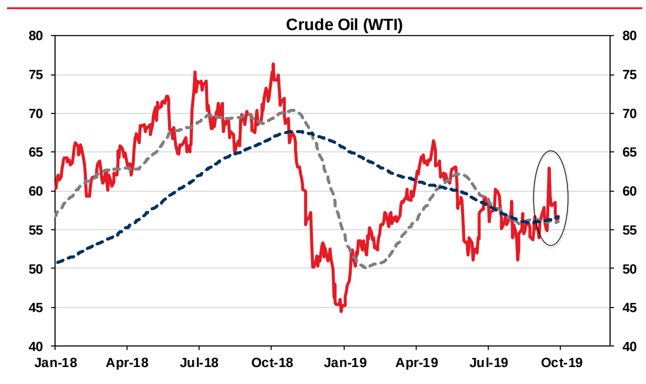
Nevertheless, the move remains well contained and thus consequences very limited, with bond benchmarks still firmly anchored in positive territory this year. For their part, Canadian preferred shares—the black sheep of the fixed-income family in 2019—regained some ground in September, posting their best monthly return since January 2017. The asset class remains largely behind year-to-date however, which tends to suffer in a falling rate environment as most of the universe is made up of securities with dividend yields benchmarked to Government of Canada 5-year treasury yields, i.e., fixed-reset (Chart 11).

The path forward is tough to call. But it should be higlighted that the valuation spread between government bonds and preferred shares—as measured by the one-year performance gap—recently reached a level which increasingly favours the latter, again, if only because of mean reversion (Chart 12).

Commodities: Is Oil a Threat?

Oil prices made the headlines in September, after attacks on Saudi Arabia's biggest crude processing center momentarily halted roughly half of the Kingdom's production (~6% of global supply), leading to a ~15% daily price surge (Chart 13).

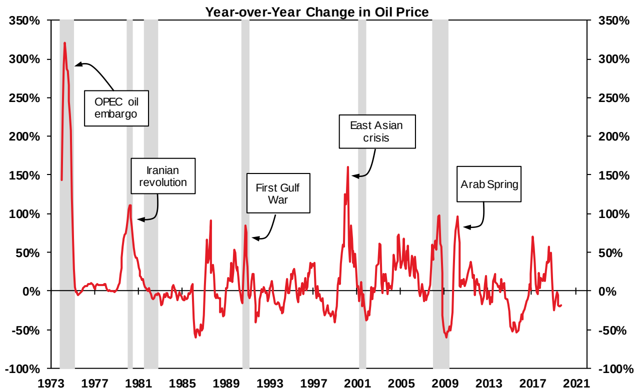
13 Sudden but short-lived surge for crude oil prices



CIO Office (data via Refinitiv).

The increase proved to be short-lived, with WTI oil prices already back to pre-attack levels, as state-owned Saudi Aramco managed to restore more than three-quarters of lost production in a matter of just two weeks. Nevertheless, this event raises questions over the risk that the world economy could be choked by a rapid and sustained rise in crude oil prices. After all, the last six U.S. recessions were preceded by sharp increases in oil prices, most of which were as a result of unexpected geopolitical events (Chart 14).

14 Are we at risk of a rapid and sustained upsurge?

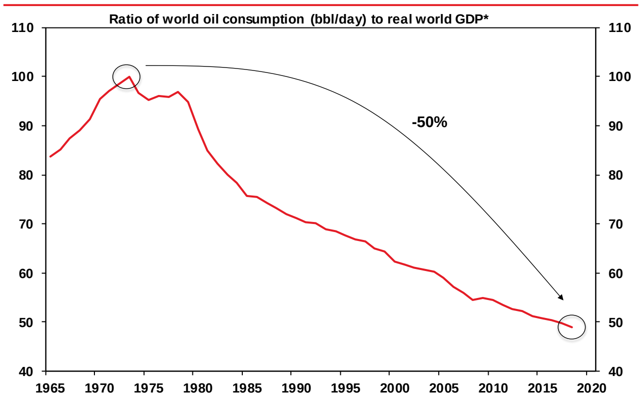


CIO Office (data via Refinitiv).

There is obviously no such thing as zero risk, especially with regard to the Middle Eastern context. Yet, aside from the fact that oil prices remain nowhere near restrictive (-29% vs. a year ago and -41% vs. five years ago), there are two fundamental changes that mitigate the risk of a disruptive oil shock.

The first is the fact that the world economy has steadily evolved to be less dependent on crude oil over the course of the last four decades, as we can see by looking at the ratio of global oil consumption to global real GDP. More specifically, every "unit" of real economic growth uses roughly 50% less crude oil than back in 1973, which mitigates the potential impact of higher prices (Chart 15).

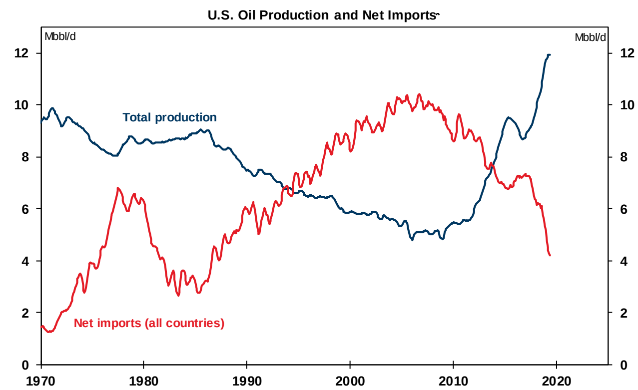
15 Global growth is less dependent on crude oil...



CIO Office (data from World Bank and BP via Refinitiv). *Rebased to January 1973 = 100

The second one concerns a significant turnaround in the United States over the past decade, namely, the increase in oil production and the subsequent decline in oil imports by our southern neighbours (of which over 87% now comes from Canada, as pointed out by our colleagues at NBF Economics and Strategy) (Chart 16). The same cannot be said for all countries, but it is still reassuring to know that the world's largest economy is less vulnerable in this regard than in the past.

16 ... and the U.S. less dependent on foreign oil

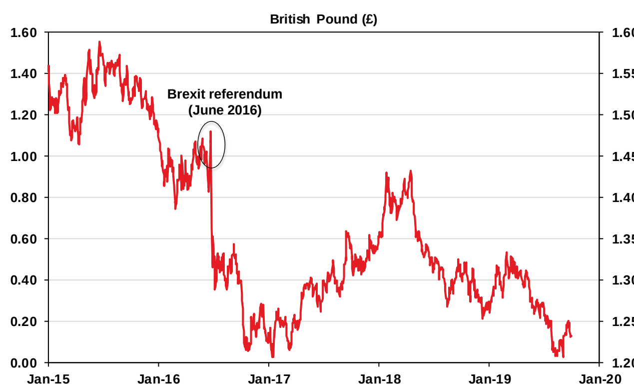


CIO Office (data via Refinitiv).

Currencies: Brexit, Season 39

The ups and downs of Brexit have been plentiful and costly for the British pound since the United Kingdom voted to withdraw from the European Union (EU) in the summer of 2016 (Chart 17).

17 The ups and downs of Brexit have been plentiful & costly



CIO Office (data via Refinitiv).

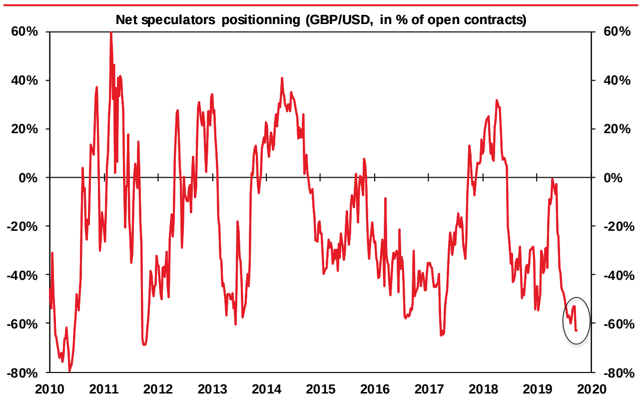
Over the last year, we have deliberately avoided emphasizing all the details of a potential Brexit for one simple reason: they change almost every week. But, now that we are entering the 39th month of the Brexit saga, it seems that a turning point in this chaotic story is about to unfold.

In short, Boris Johnson's risky strategy to suspend Parliament in a push to deliver Brexit at all costs ultimately resulted in him losing his majority, failing to secure an early election, and failing to keep alive the no-deal option—all before it was ruled unlawful by the Supreme Court, forcing him back into Parliament.

Now, there is no shortage of scenarios for what will happen this month, with Boris Johnson working on a last-ditch attempt to reach a Brexit deal that meets the demands of all. Yet, the British Prime Minister is likely to be forced on October 19 to ask the EU for a third Brexit extension beyond the current deadline of October 31, which could open the door to an election soon after.

To be clear, nobody (including Members of Parliament) knows how this is truly going to turn out, and that's certainly not a bet we're willing to take. The only certainty is that October will be busy in the U.K. and, judging by the significant short Pound positioning by speculators, this could lead to wild swings for the British currency (Chart 18). Stay tuned.

18 Will speculators be right in being this pessimistic?

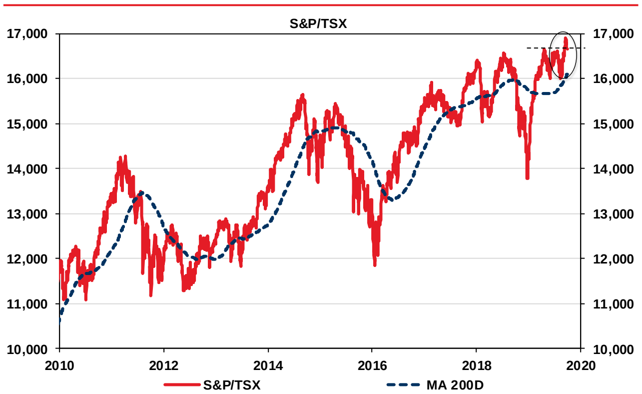


CIO Office (data via Refinitiv).

Equities: Winds of Change?

Canadian equities broke through an all-time high in September (Chart 19), benefitting from sharp gains in the energy (+5.6%) and financial (+6.8%) sectors, its two heavyweights (Chart 20).

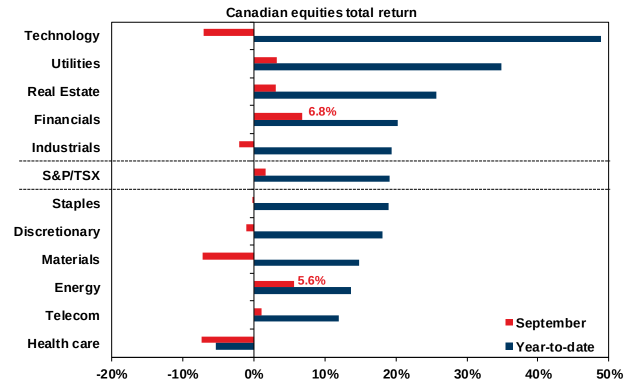
19 **New record high for the Canadian equity market…**



CIO Office (data via Refinitiv).

Despite this record for the Canadian stock market, it was actually the EAFE region which finished first last month, up 2.9% (vs. 1.7% for the S&P/TSX). However, the move failed to

20 **… benefitting from gains in the more cyclical sectors**

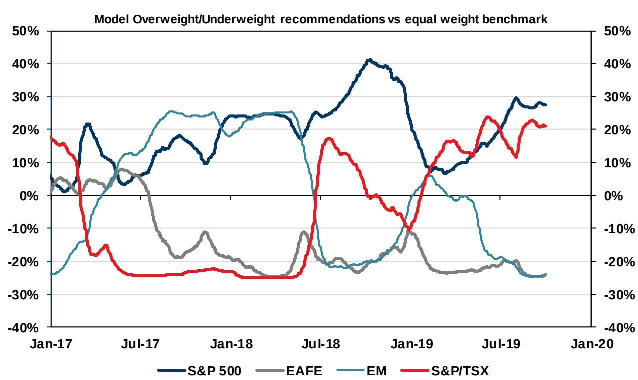


CIO Office (data via Refinitiv).

significantly alter the call from our relative momentum model, which still largely favours North American equities (Chart 21).

Looking beyond momentum, our basic thesis as we initiated our North American overweight was that the Canadian market's lower volatility and lower valuation made it an attractive alternative in the current tense context, while the more volatile U.S. stocks would ultimately benefit from a resilient economy and flexible Central Bank. In contrast, growth in Europe and emerging markets seemed more likely to suffer in an environment where global trade was under pressure.
Since then, economic data have effectively shown that growth prospects compare favourably on our side of the Atlantic. This is in part reflected in forward earnings revisions—positive in North America, negative elsewhere (Chart 22, next page).

21 No significant change in relative momentum

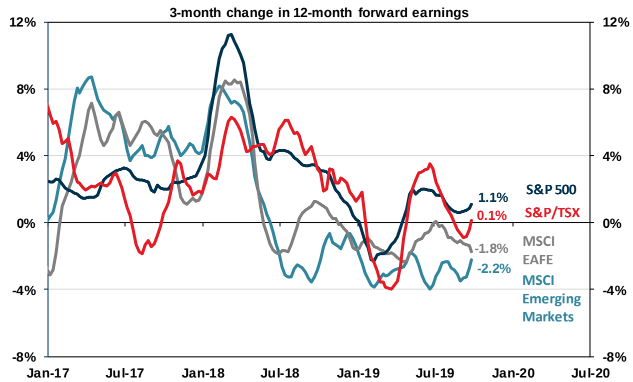


CIO Office (data via Refinitiv).

On a valuation basis, we note that price-earnings multiples have barely changed from a quarter earlier, with the S&P/TSX still the only index trading with a ratio near its last ten-year average (Chart 23, next page).

As such, we are maintaining our bias in favour of the S&P 500 and S&P/TSX for now. It is possible that the more cyclical European equity market could catch up against the growth-oriented S&P 500 in the months to come, should a rebound in global economic activity materialize and push bond yields

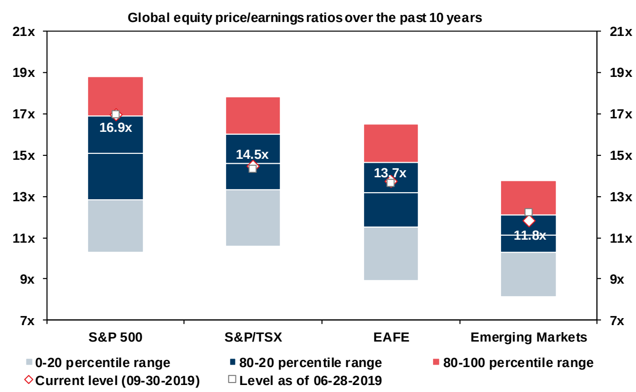
22 Better growth prospects in North America



CIO Office (data via Refinitiv).

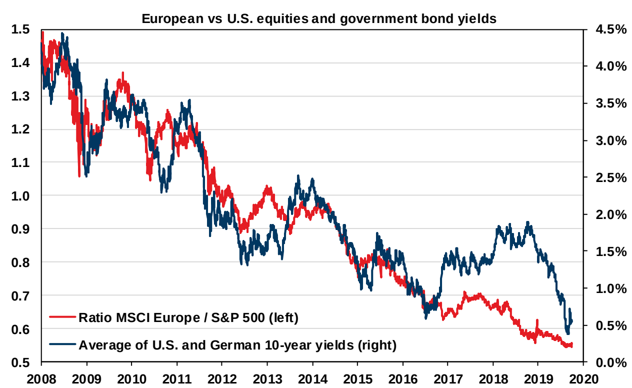
higher (Chart 24). Yet, we believe to be better positioned for this possibility by owning more Canadian stocks—also very much cyclical—which have the notable advantage of not having a Brexit-shaped sword of Damocles hanging over them.

23 Price/Earnings multiples **are holding steady**



CIO Office (data via Refinitiv).

24 A cyclical upturn would likely favour Europe



CIO Office (data via Refinitiv).

CIO Office

CIO-Office@nbc.ca

Martin Lefebvre
CIO and Strategist
martin.lefebvre@nbc.ca

Simon-Carl Dunberry
Chief Analyst
simon-carl.dunberry@nbc.ca

Louis Lajoie
Principal Analyst
louis.lajoie@nbc.ca

Nicolas Charlton
Analyst
nicolas.charlton@nbc.ca

General

The present document was prepared by National Bank Investments Inc. (NBI), a wholly owned subsidiary of National Bank of Canada. National Bank of Canada is a public company listed on the Toronto Stock Exchange (NA: TSX).

The information and the data supplied in the present document, including those supplied by third parties, are considered accurate at the time of their printing and were obtained from sources which we considered reliable. We reserve the right to modify them without advance notice. This information and data are supplied as informative content only. No representation or guarantee, explicit or implicit, is made as for the exactness, the quality and the complete character of this information and these data. The opinions expressed are not to be construed as solicitation or offer to buy or sell shares mentioned herein and should not be considered as recommendations. The opinions are not intended as investment advice nor are they provided to promote any particular investments and should in no way form the basis for your investment decisions. National Bank Investments Inc. has taken the necessary measures to ensure the quality and accuracy of the information contained herein at the time of publication. It does not, however, guarantee that the information is accurate or complete, and this communication creates no legal or contractual obligation on the part of National Bank Investments Inc.

NBI or its affiliates often act as financial advisor, agent or underwriter for certain issuers mentioned herein and may receive remuneration for its services. As well NBI and its affiliates and/or their officers, directors, representatives, associates, may have a position in the securities mentioned herein and may make purchases and/or sales of these securities from time to time in the open market or otherwise.

This document is for distribution only under such circumstances in Canada and to residents of Canada as may be permitted by applicable law. This document is not directed at you if NBI or any affiliate distributing this document is prohibited or restricted by any legislation or regulation in any jurisdiction from making it available to you. You should satisfy yourself before reading it that NBI is permitted to provide this document to you under relevant legislation and regulations.

Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments (the “Funds”). Please read the prospectus of the Funds before investing. The Funds’ securities are not insured by the Canada Deposit Insurance Corporation or by any other government deposit insurer. The Funds are not guaranteed, their values change frequently and past performance may not be repeated.

© 2019 National Bank Investments Inc. All rights reserved. Any reproduction, in whole or in part, is strictly prohibited without the prior written consent of National Bank Investments Inc.

® NATIONAL BANK INVESTMENTS is a registered trademark of National Bank of Canada, used under license by National Bank Investments Inc.