



The Real Deal

Highlights

- > Stock markets pursued their recovery into the second half of the year, supported by a rebound in economic activity and positive advances in medical research against COVID-19. Nevertheless, this doesn't mean we are out of the woods yet, with U.S. initial jobless claims still higher than the peaks of the last 7 recessions. Overall, these developments are in line with our base-case scenario which calls for a sustained, albeit more moderate and bumpy recovery in economic growth over the coming months.
- > Could U.S. elections throw equity markets off course? That's not what history suggests. While on average, the U.S. stock market stalled in the 3 months preceding the last 10 Presidential elections, gains were generally observed over the following 12 months. Obviously, 2020 is anything but an "average" year, and the run-up to the election is likely to raise investor nervousness knowing that Democrats plan to raise the corporate tax rate. Yet, this should not put an end to the ongoing economic recovery.
- > A key factor behind our confidence in the recovery is the monetary environment in which we find ourselves. Beyond exogenous factors such as the COVID-19 pandemic, the main threat to business cycles is usually an overly restrictive monetary policy. However, recent months have seen real rates plunge to their lowest levels in over 7 decades, with central banks favouring negative real interest rates, much like they did after the previous two world wars. In concrete terms, we should not expect Fed rate hikes between now and the end of 2022. This also implies that bond markets are unlikely to be as profitable as they have been in recent years, particularly government securities.
- > Gold prices surged to a record high in July, thanks to lower real yields and a weaker U.S. dollar. Now that prices are nearing \$2,000 per ounce, are we still as optimistic as we were 3 months ago? We wouldn't be surprised to see gold take a breather after an almost meteoric rise. However, the reality is that the macroeconomic environment should remain highly favourable for the commodity, with further U.S. dollar weakness on the horizon.
- > The S&P 500 is still leading in 2020, thanks to its 5 largest stocks – the FAAMGs – without which the Index would be almost 8% lower. Will the tech train ever stop? The altitude at which technology companies are flying means that turbulence is to be expected. This is all the more true, given that they are in the crosshairs of U.S. politicians on the campaign trail and in the portfolios of a growing pool of daily speculators. However, as long as monetary conditions remain accommodative and COVID-19 remains a threat, they will likely continue to outperform.
- > In this context, we are maintaining our slight overweight in U.S. equities. On the other hand, we have increased our allocation to emerging markets in exchange for a reduction in our Canadian equity allocation. This aligns our positioning directly with the recommendations of our GRT model. EMs should be the main beneficiaries of an eventual rotation caused by a marked advance in the fight against the coronavirus, and sustained period of U.S. dollar weakness.

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

- > U.S. government bond rates inched lower throughout the month of July, even as inflation expectations improved, helping longer-term bonds outperform their shorter-duration counterparts.
- > The nominal rate on the 10-year U.S. note now stands near a record low, while real rates slipped below negative 1%.
- > Meanwhile, credit spreads further tightened as a balance of positive economic data releases hinted at an ongoing recovery.

Canadian Equities

- > With just over a quarter of the S&P/TSX companies having reported so far, this earnings season has so far seen close to 60% of companies beating the consensus estimates.
- > Still down year-to-date, Canadian equities nonetheless closed the gap, as every sector posted gains this month, led by Materials and IT stocks.

U.S. Equities

- > South of the border, the S&P 500 closed out July positive year-to-date, a first since the beginning of the pandemic.
- > This occurred amid the economy's worst post-war contraction on record, as GDP is predicted to have fallen by a whopping annualized 33% during the second quarter.
- > On the other hand, more timely measures of economic health such as estimated earnings growth continued to improve from their recent lows. Case in point: over 82% of S&P 500's companies that have reported so far have beaten their consensus estimates.
- > While the Energy sector fell markedly following the latest GDP release, all other sectors remained positive for the month, with broad gains shared among both cyclical and defensive stocks.

Commodities

- > The price of gold reached a new record last month, spurred on by a supportive combination of a weakening USD and falling real rates.
- > The lustrous metal was not alone in its impressive climb, with other metals such as copper and silver rising to meet growing demand from a world economy slowly awakening from its COVID-induced slumber.
- > On the other hand, the WTI price remained flat throughout the month, even as total crude-oil inventory ticked down in the U.S.

Foreign Exchange

- > The U.S. dollar suffered a broad-based decline last month, as evidenced by comparative rises in the Yen, Euro, and Pound Sterling, making July the Greenback's worst month since September 2010.
- > Expectations that interest rate differentials between the U.S. and partner countries would remain low for some time weakened demand for the safe-haven currency.
- > The Loonie also benefitted from USD weakness, closing out the July near a 5-month high.

Table 2 Market Total Returns

Asset Classes	July	YTD	12 months
Cash (3-month T-bills)	0.0%	0.8%	1.5%
Bonds (FTSE CA Ovr. Univ.)	1.3%	8.9%	9.1%
FTSE CA Short term	0.5%	4.5%	5.0%
FTSE CA Mid term	1.0%	9.4%	9.1%
FTSE CA Long term	2.4%	14.0%	14.1%
FTSE CA Government	1.1%	9.5%	9.4%
Federal	0.5%	8.1%	7.9%
Provincial	1.5%	10.7%	10.7%
Municipal	1.7%	10.0%	10.3%
FTSE CA Corporate	1.9%	7.4%	8.1%
AA+	0.9%	5.4%	6.0%
BBB	2.1%	7.3%	8.2%
BoAML Inv. Grade (\$US)	3.2%	8.1%	12.0%
BoAML High-Yield (\$US)	4.8%	-0.2%	3.1%
Preferred Shares	6.4%	-5.5%	-2.6%
Canadian Equities (S&P/TSX)	4.5%	-3.3%	1.9%
Energy	1.1%	-29.6%	-20.7%
Industrials	5.7%	1.6%	3.5%
Financials	0.8%	-15.5%	-11.3%
Materials	13.1%	30.5%	38.1%
Utilities	6.1%	4.3%	15.1%
Cons. Disc	4.2%	-7.1%	-9.9%
Cons. Staples	6.3%	7.6%	7.8%
Healthcare	1.2%	-30.1%	-46.9%
IT	6.1%	71.9%	90.7%
Comm. Svc.	1.3%	-7.8%	-4.0%
REITs	3.2%	-17.5%	-14.4%
S&P/TSX Small Cap	7.4%	-8.0%	-6.4%
US Equities (S&P500 USD)	5.6%	2.4%	12.0%
Energy	-5.1%	-38.7%	-38.3%
Industrials	4.3%	-10.9%	-5.7%
Financials	3.8%	-20.7%	-12.8%
Materials	7.1%	-0.3%	6.3%
Utilities	7.8%	-4.2%	5.8%
Cons. Disc	9.0%	16.9%	21.6%
Cons. Staples	7.0%	0.9%	8.1%
Healthcare	5.4%	4.5%	18.8%
IT	5.6%	21.4%	38.9%
Comm. Svc.	6.8%	6.5%	14.8%
REITs	4.0%	-4.9%	0.2%
Russell 2000 (USD)	2.7%	-11.3%	-6.0%
World Eq. (MSCI ACWI)	5.3%	-1.0%	7.8%
MSCI EAFE (USD)	2.4%	-9.0%	-1.2%
MSCI EM (USD)	9.0%	-1.5%	6.9%
Commodities (CRB index)	4.9%	-5.9%	-6.3%
WTI Oil (US\$/barrel)	1.3%	-34.9%	-32.1%
Gold (US\$/ounce)	10.7%	29.9%	38.3%
Copper (US\$/tonne)	7.0%	4.4%	8.8%
Forex (DXY - US Dollar index)	-4.1%	-3.2%	-5.2%
USD per EUR	5.3%	5.3%	6.2%
CAD per USD	-1.2%	3.3%	1.7%

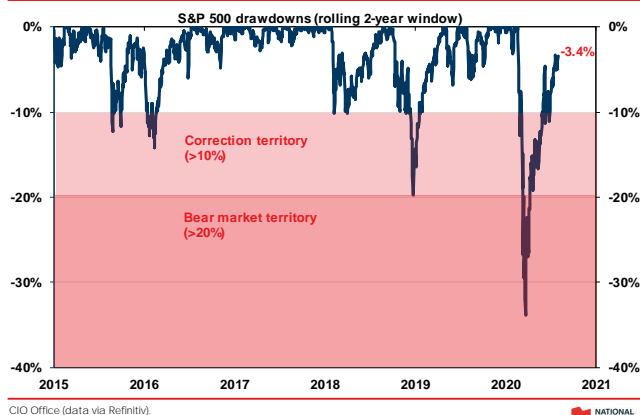
CIO Office (data via Refinitiv)

7/31/2020

The Real Deal

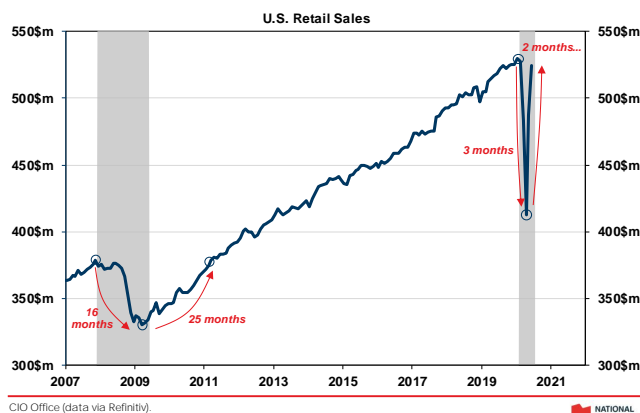
Stock markets pursued their recovery into the second half of the year, taking the S&P 500 index only 3.4% below its February 19 peak (Chart 1).

1 The U.S. stock market is nearing a new high...



This strong showing reflects a significant rebound in several economic figures observed in recent months, notably retail sales which also stand exactly 3.4% below their pre-Covid peak of just 5 months ago. This data is a vivid illustration of how different the current backdrop is from the last recession (thanks to significant fiscal stimulus), which saw retail sales plummet and recover over the span of 41 months instead (Chart 2).

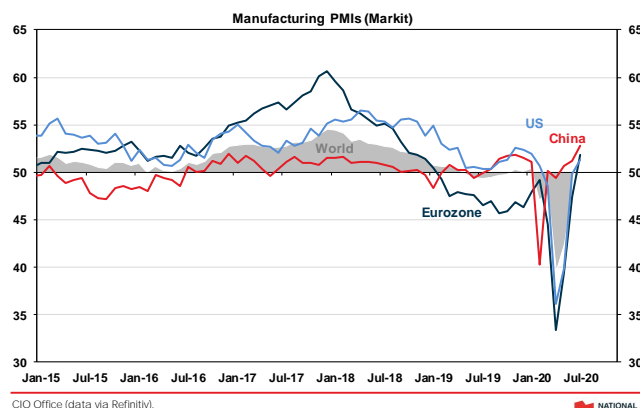
2 ... much like retail sales



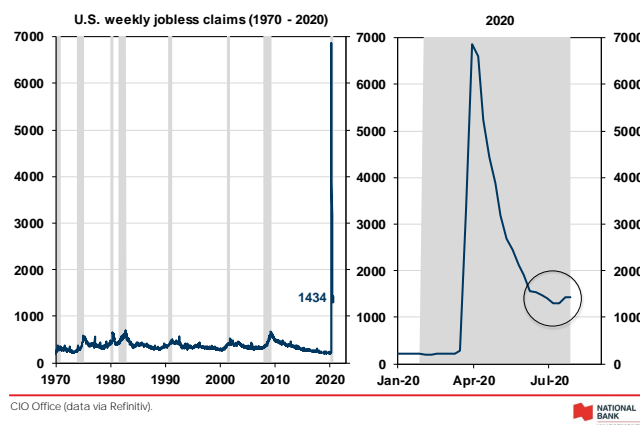
An upturn in economic activity was also observed globally, as manufacturing production indices in China, the Eurozone, and the United States all returned into expansion territory (PMI>50, Chart 3).

In short, recent months have brought their fair share of good news – particularly on the economic side, but also in terms of medical research – and that explains the stock market rally. Nevertheless, this doesn't mean we are out of the woods yet. Case in point: U.S. initial jobless claims remain higher than the peaks of the last 7 recessions and have plateaued in recent weeks (Chart 4).

3 Global growth is picking up...

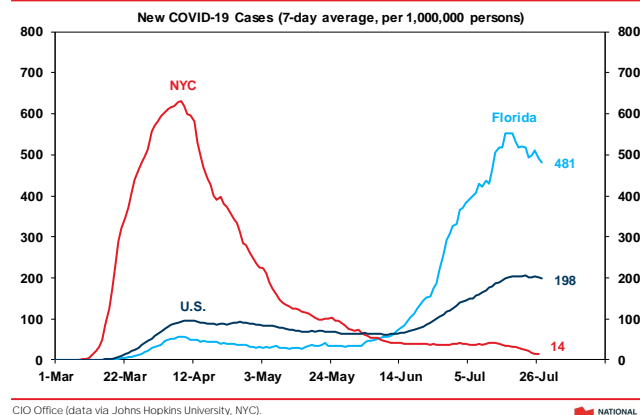


4 ... but bumps along the road to recovery are expected...



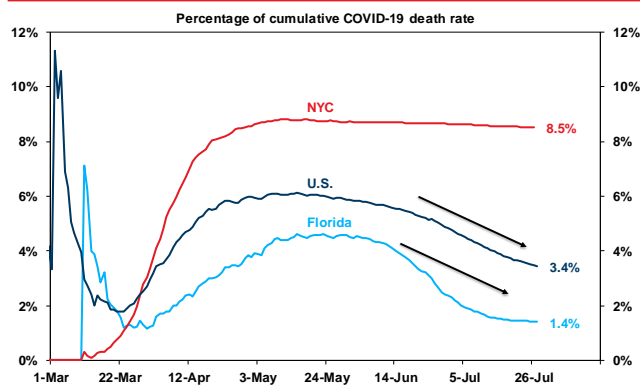
Overall, these developments are in line with our base-case scenario which calls for a sustained, albeit more moderate and bumpy recovery in economic growth over the coming months. A key factor behind this last point is that COVID-19 outbreaks are likely to continue to emerge in different regions and at different times, as observed in Florida, in July, for example (Chart 5).

5 ... due to the persistence of COVID-19...



Yet, this is likely to weigh on the pace, not on the sustainability of the recovery. A re-run of the March chaos would be highly surprising, notably due to better management of the virus (more tests, more protection of the population at risk, progress in medical research), as mirrored by the downward trend in mortality rates south of the border (Chart 6).

6 ... which we are learning to live with



CIO Office (data via Johns Hopkins University, NYC)

Could U.S. elections – which are in 3 months' time – throw equity markets off course? That's not what history suggests. While, on average, the U.S. stock market stalled in the 3 months preceding the last 10 Presidential elections (+0.5%), gains were generally observed over the following 12 months (+14.1% on average, and positive 9 times out of 10) (Chart 7).

7 Should we be fearful of Presidential elections?...

S&P 500 total return around U.S. presidential elections

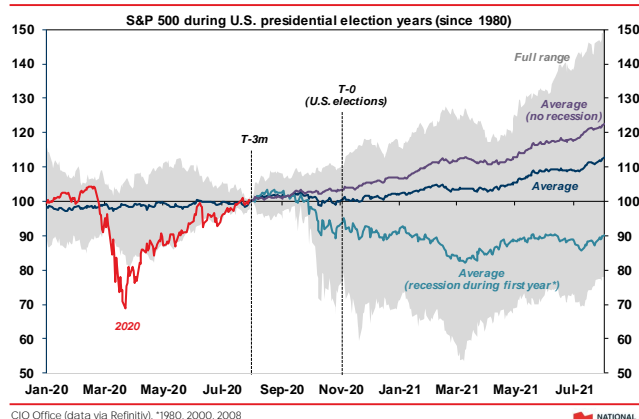
Election Year	3-months before	3-months after	6-months after	12-months after
2016	-1.3%	7.8%	13.3%	23.7%
2012	3.0%	6.5%	14.5%	26.8%
2008	-19.0%	-16.6%	-8.4%	6.9%
2004	2.6%	6.0%	3.7%	9.4%
2000	-2.9%	-6.1%	-11.2%	-21.0%
1996	8.8%	9.5%	17.4%	34.5%
1992	-0.4%	7.2%	6.8%	13.4%
1988	2.9%	9.5%	13.2%	27.2%
1984	5.8%	7.5%	7.3%	16.7%
1980	5.5%	1.4%	5.7%	3.3%
Average	0.5%	3.3%	6.2%	14.1%
Positive / Total	6/10	8/10	8/10	9/10

CIO Office (data via Refinitiv)

Obviously, 2020 is anything but an "average" year, and so it would be overly simplistic to stop the analysis here. In fact, a closer look at history shows that what explains the divergence in market behaviour around Presidential elections is not the political affiliation of the new President, Senate, or House of Representatives. Rather, "it's the economy, stupid," as the adage popularized by the 1992 Bill Clinton Presidential campaign would put it (Chart 8).

Therefore, could November election results – which for now are seemingly heading toward a landslide victory for the

8 ... We should be fearful of recessions



CIO Office (data via Refinitiv) *1980, 2000, 2008

Democrats (Chart 9) – cause serious economic damage? The run-up to the election is likely to raise investor nervousness knowing that Democrats plan to raise the corporate tax rate from 21% to 28% (it was 35% before the 2017 Trump tax reform) – something they will certainly be able to accomplish should they win the Presidency and majorities in both the House and the Senate.

9 Democrats have the lead



CIO Office (data via *Predictit)

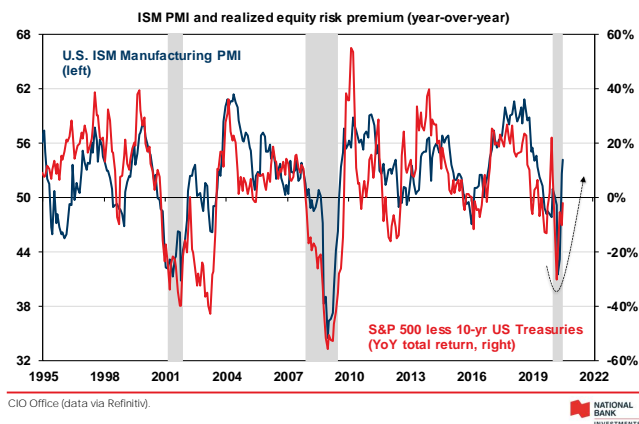
At first sight, this is not the most bullish scenario for the stock market. The 2017 tax cut raised S&P 500 earnings by about 12% in 2018. Thus, a rule of thumb suggests that reversing half of this cut would reduce 2022 earnings by about 6%.

On the other hand, let us not forget that what markets hate above all is uncertainty. A Biden administration would certainly be more stringent on businesses and the wealthy, but it would also be more predictable, especially with respect to its foreign policy. In addition, total fiscal stimulus may even be greater than under a Trump administration as the Democrats' agenda also entails a sharp increase in spending. In short, none of this points to serious economic damage as a result of the November 3 election.

Under these circumstances, the economic recovery initiated in recent months should continue over the coming year. Equity markets should therefore outperform more defensive bonds

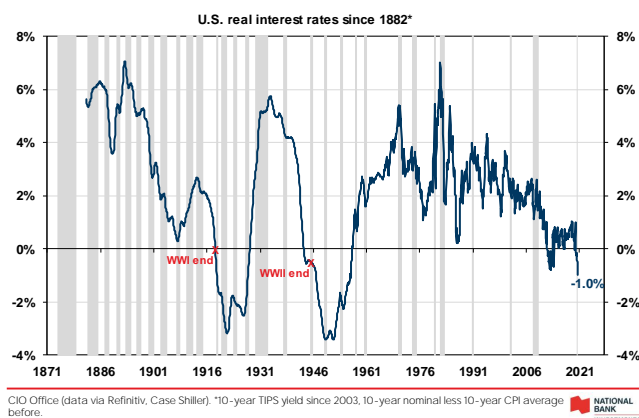
(Chart 10), although we still advocate a moderate approach to risk-taking given the prevailing uncertainty.

10 Cyclical outlook still supportive for equities...



A key factor behind our confidence in the recovery is the monetary environment in which we find ourselves. Beyond exogenous factors such as the COVID-19 pandemic, the main threat to business cycles is usually an overly restrictive monetary policy. However, recent months have seen real rates (i.e., inflation-adjusted nominal rates) plunge to their lowest levels in over seven decades, with central banks favouring negative real interest rates, much like they did after the previous two world wars (Chart 11).

11 ... with monetary conditions evoking the post-war era(s)



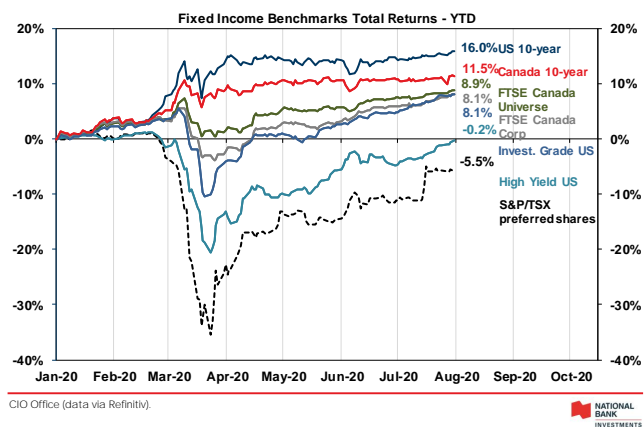
Fixed Income: Quiet

Fixed-income markets continued to trade in a relatively calm manner in July, with government bonds stalling and assets with credit risk gradually rising (Chart 12).

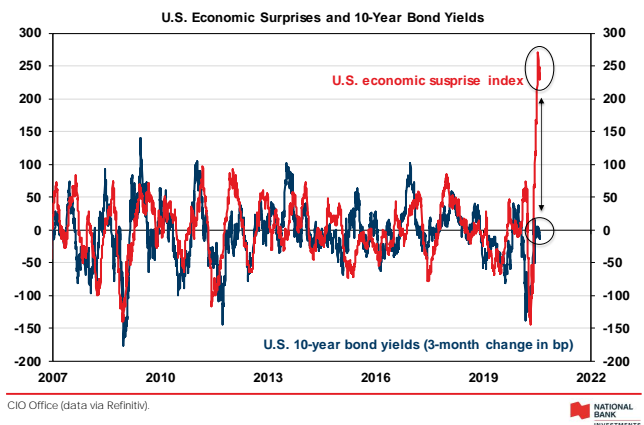
Under normal circumstances, positive economic surprises from recent months would have triggered sharp movements in Treasury bills. Yet, U.S. 10-year government bond yields have barely changed since the end of March (Chart 13).

Does this mean that the bond market doesn't believe in the economic recovery? Not so fast. It primarily reflects the effectiveness of actions taken by the Federal Reserve so far.

12 Relative calm for fixed income assets in July...

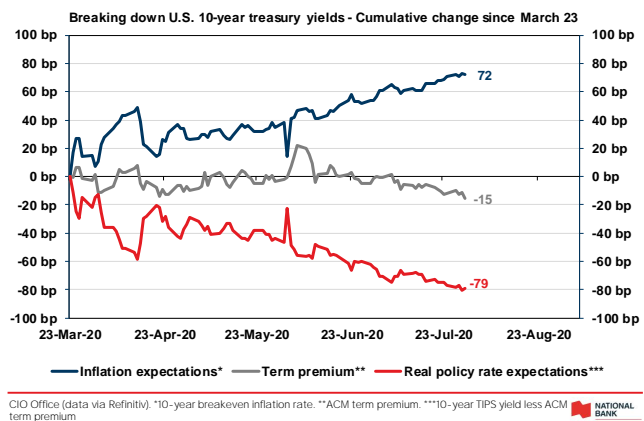


13 ...despite the magnitude of economic surprises...



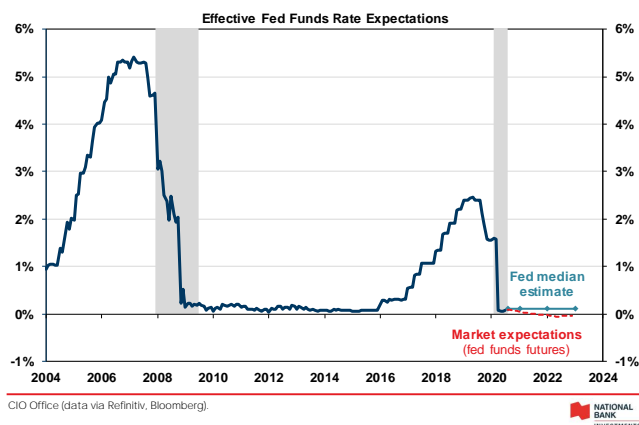
Indeed, a look under the hood of 10-year bond yields shows that the last few months have been characterized by a recovery in inflation expectations and an equivalent decline in real policy rate expectations – precisely the central bank's objective (Chart 14).

14 ... mirroring actions taken by the Federal Reserve...



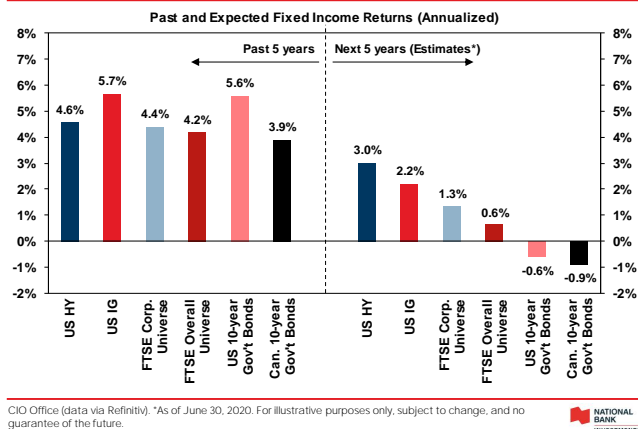
Clearly, the Fed's intention to keep its reference rate near zero for as long as it takes for inflation to return to target has been heard. In concrete terms, this means that we should not expect rate hikes between now and the end of 2022 (Chart 15).

15 ... which is unlikely to raise rates any time soon



This backdrop also implies that bond markets are unlikely to be as profitable as they have been in recent years, particularly government securities (Chart 16). This is one of the key conclusions of our annual *Long-Term Market Expectations* report that we published last month and encourage you to consult.¹

16 Past performance is no guarantee of the future for bonds

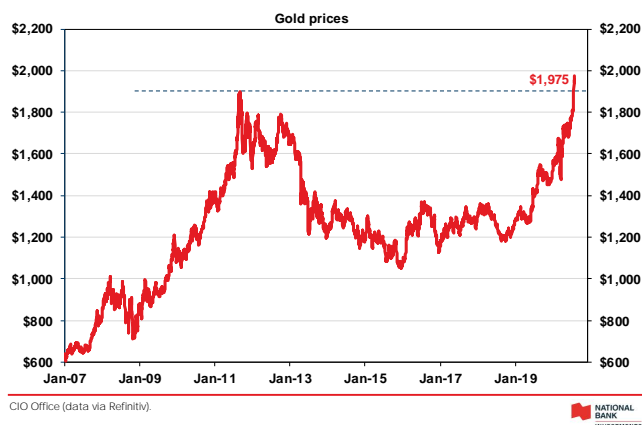


Commodities: Goldilocks for Gold

The price of gold surged to a record high in July, up 30% year-to-date and 34% from its March 19 low of \$1475 per ounce (Chart 17).

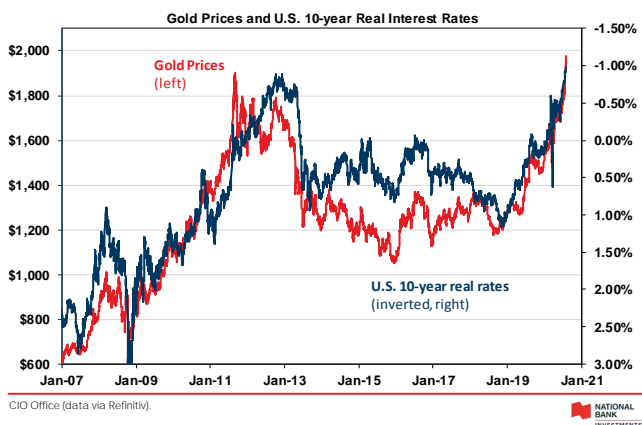
Recall that in March, many were questioning gold's poor performance at the height of the crisis. At that time, we argued that it was only natural to see the commodity retreat in a context where inflation expectations collapse (i.e. real interest rates rise) and the U.S. dollar soars, as is to be expected during a major economic shock. However, the strong likelihood of a reversal in these two key cyclical forces, owing to massive

17 The price of gold surged to a record high in July...



central bank interventions, led us to conclude that gold prices were set to rise. This is what happened in the post-financial crisis rebound, and this is effectively what has ended up happening in recent months (Charts 18).

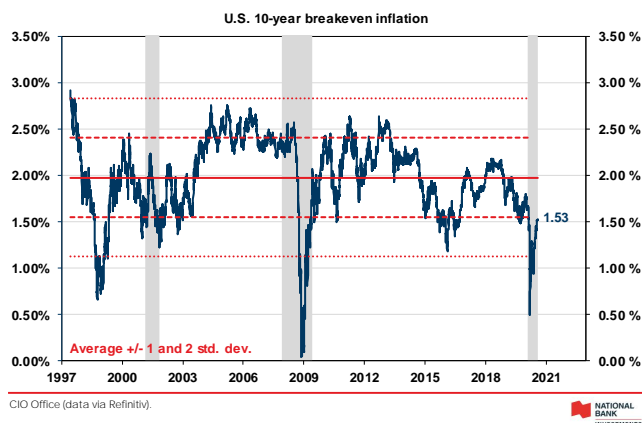
18 ... with real yields continuing to fall...



Now that prices are nearing \$2,000 per ounce, are we still optimistic about the commodity? In the short term, we wouldn't be surprised to see gold take a breather after an almost meteoric rise. However, the reality is that the macroeconomic environment should remain highly favourable for gold. Its main threat – an increase in real rates – is unlikely at this stage, whereas we are more likely to see a gradual rise in inflation expectations, still one standard deviation below their long-term average (Chart 19, next page). Moreover, the stars look increasingly aligned for a period of U.S. dollar weakness.

¹ <https://www.nbinvestments.ca/content/dam/bni/publication/long-term-market-expectations.pdf>

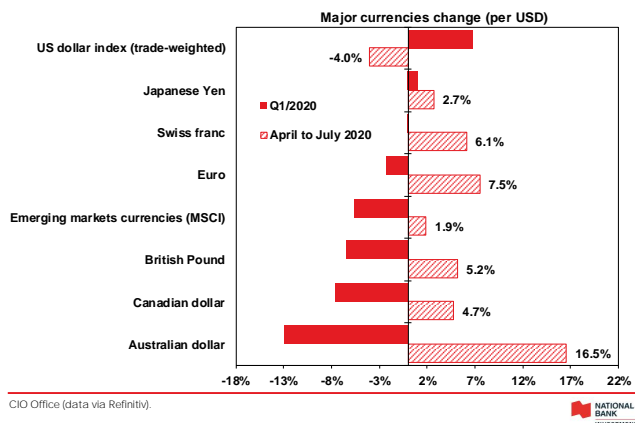
19 ... as inflation expectations recover



Currencies: Headwind for the Dollar

The U.S. dollar remained on a downward trend in July, with all major currencies posting gains against the Greenback over the last 4 months and in sharp contrast to the first quarter of the year (Chart 20).

20 Change of course for the US dollar...



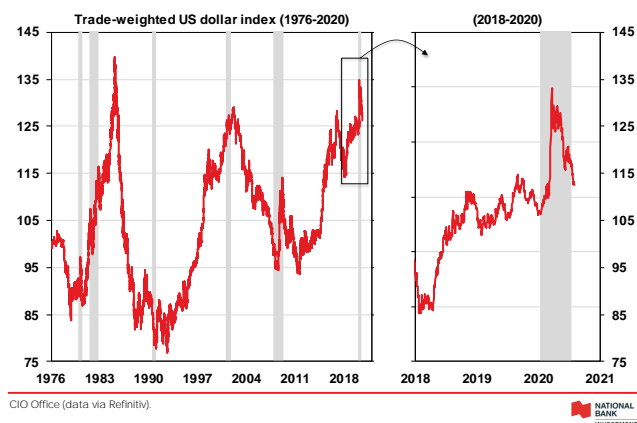
The world's main reserve currency nevertheless remains strong on an historical basis, as evidenced by a look at its trade-weighted index since 1976 (Chart 21). But, headwinds are picking up.

For one, the counter-cyclical properties of the U.S. dollar should play against the currency over the next year, if economic activity continues to grow in line with our anticipations (Chart 22).

For another, positive interest-rate differentials – which made U.S. currency more attractive on a relative basis since 2015 – have largely disappeared since the Federal Reserve dropped its target rate to its floor (Chart 23).

Finally, the size of the budget deficit could also end up weighing on the currency over the longer term (Chart 24, next page). For now, this effect is mitigated, given that virtually all countries are in deficit mode. However, nothing indicates that the U.S.

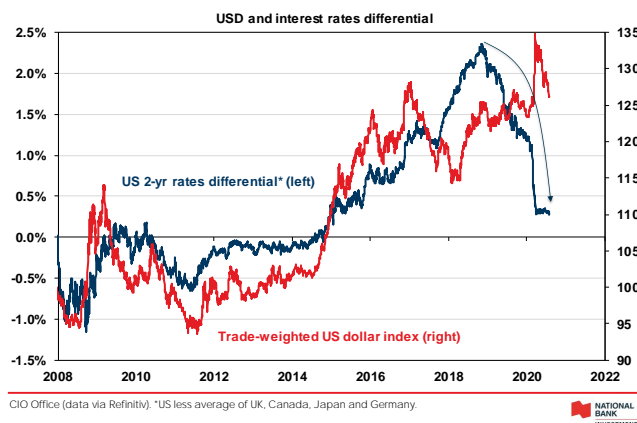
21 ... and the downward journey could be long...



22 ... in light of the resumption of global growth...



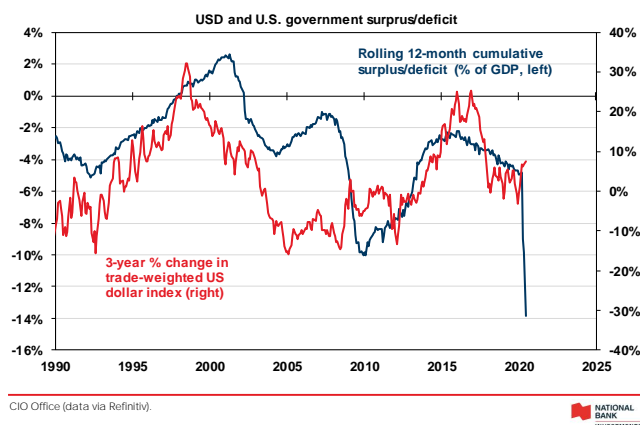
23 ... the narrowing of positive interest rate differentials...



government will be the most conservative in this regard in the coming years. After all, the U.S. Federal deficit was already heading toward 5% of GDP when we were near full employment before the crisis.

Why is it that the dollar is not depreciating faster if everything is pointing in that direction? In our view, this reflects the fragility of the current economic recovery, which remains dependent on

24 ... and soaring budget deficits

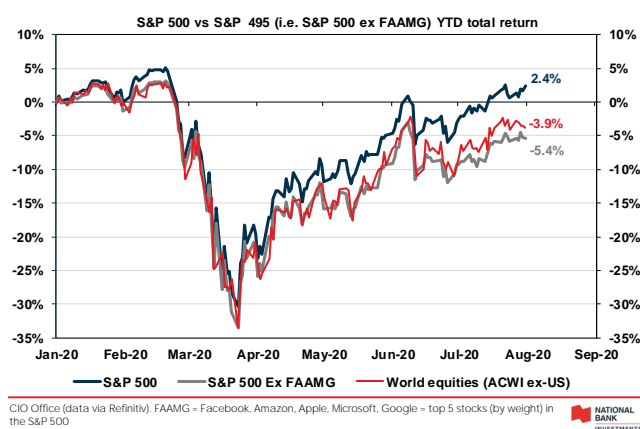


our ability to find a permanent solution to the COVID-19 pandemic. Therefore, its decline should remain contained as long as investors have an appetite for safe havens. However, a positive resolution to the current health crisis could trigger a rapid rotation out of U.S. dollar-denominated assets. This would have implications for equity leadership.

Equities: Will the Tech Train Ever Stop?

U.S. equities are still leading in 2020, having formally closed out July in positive territory YTD (+2.4% total return in US\$) – a feat that has yet to be achieved by emerging markets (-1.5%), Canada (-3.3% in C\$), and the EAFE region (-9.0%). However, this dominance is essentially the product of the S&P 500's 5 largest stocks – the FAAMGs – without which the Index would be almost 8% lower (Chart 25).

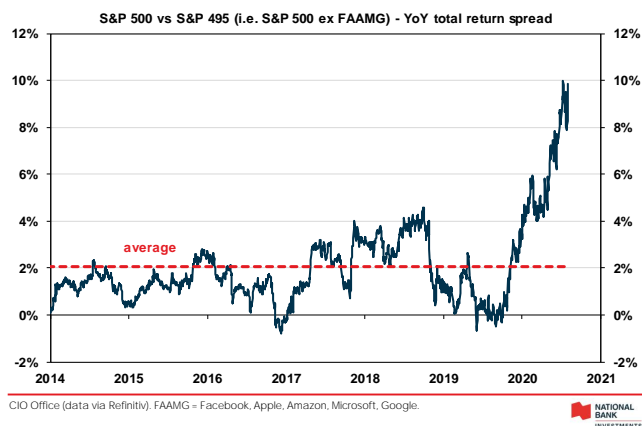
25 U.S. equities are still #1 ... thanks to the FAAMG ...



The sustainability of the rally in tech giants has been a subject of continuous debate among investors for several years now. As we mentioned many times, U.S. equities' strong bias towards technology names is one of the fundamental reasons behind our preference for the U.S. market, which we've held almost continuously for two years now.² Still, we must recognize that the impact of these 5 stocks on the overall Index (on average

+2% per year since 2014) has reached a level that demands reconsideration (Chart 26).

26 ...that are pulling up the S&P 500 more than ever before



So, will the tech train ever stop? We obviously don't have a crystal ball, but logic suggests the train will keep on going as long as the main forces supporting this remain in place.

One of them is easy monetary policies. Since high-growth companies derive much of their value from future profits (i.e., they have longer duration), they are more sensitive to changes in discount rates. Thus, a rise in policy rates by central banks combatting inflation is a key threat to such companies. As proof, recall the plunge in technology stocks in Q4-2018 when the Fed had just completed its fourth hike of the year and was planning to take rates into restrictive territory in 2019. Today, the Fed motto is "we're not even thinking about thinking about raising rates," as Jerome Powell said in his last 2 press conferences. This should continue to play in favour of technology giants.

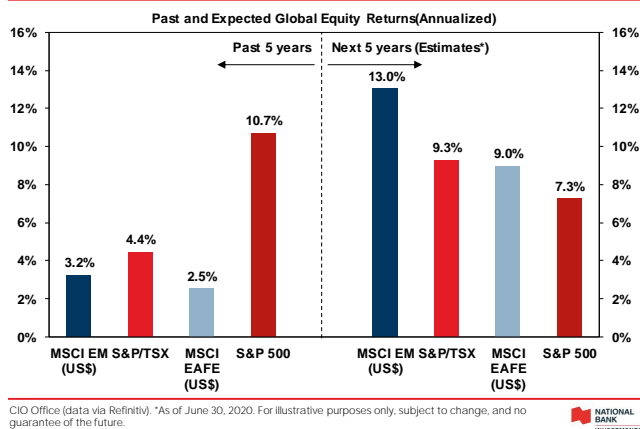
Another driving force is the substantial advantage their business model provides in a world of social distancing, showcased by their most recent earnings reports. As long as the economic recovery is challenged by the persistence of COVID-19, appetite for these more defensive companies is likely to persist. On the other hand, a definitive solution to the virus (i.e., an effective vaccine ready for distribution) could trigger a significant rotation out of these U.S. companies. In this scenario, investors are likely to turn to lagging regions whose valuations and economic fundamentals suggest higher expected returns (Chart 27, next page).

So, what can we conclude? The altitude at which technology companies are flying means that turbulence is to be expected. This is all the more true, given that they are in the crosshairs of U.S. politicians on the campaign trail and in the portfolios of a growing pool of daily speculators. However, as long as monetary conditions remain accommodative and COVID-19 remains a threat, these companies will likely continue to outperform.

In this context, we are maintaining our slight overweight in U.S. equities. On the other hand, we have increased our allocation

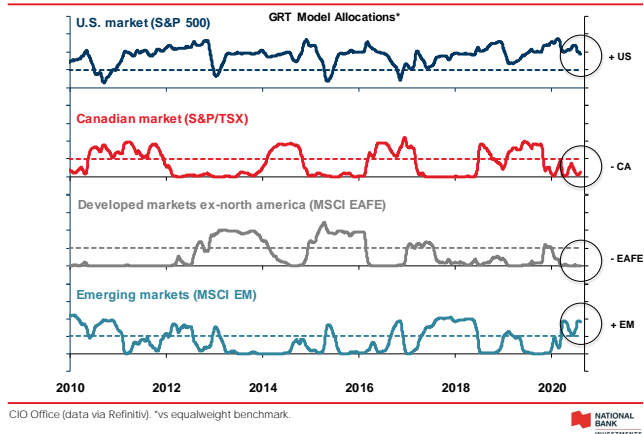
² The only exception is the 3-month period between February and May 2019, where we were neutral.

27 Will there ever be a rotation out of the U.S.?



to emerging markets in exchange for a reduction in our Canadian equity allocation. This aligns our positioning directly with the recommendations of our GRT Model (Chart 28).

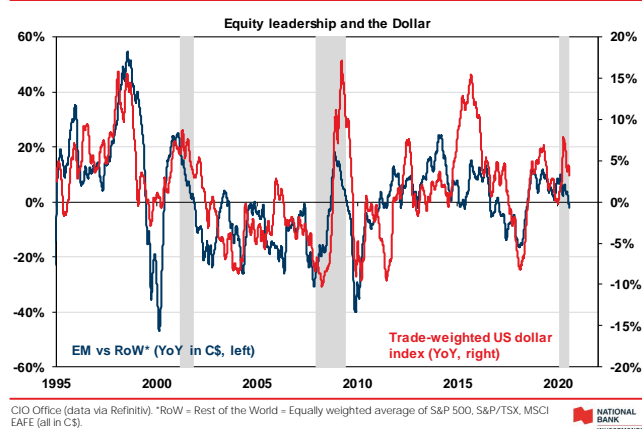
28 Alignment of our positioning with our model



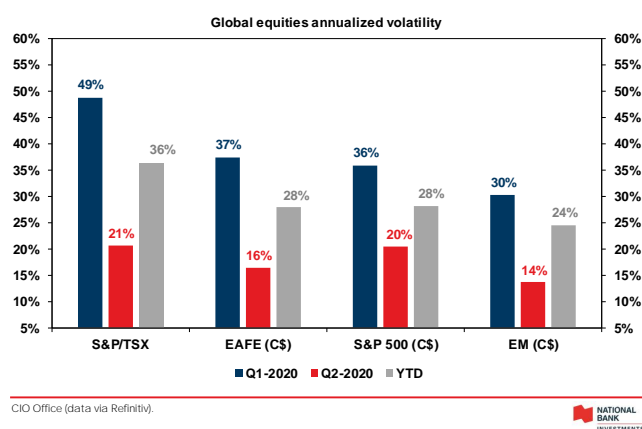
Beyond the Model, we expect emerging markets – which show the highest long-term expected returns according to our estimates – to be the main beneficiaries of an eventual rotation caused by advances in the fight against the coronavirus. As detailed in the currency section, this would likely prompt U.S. dollar depreciation, which benefits emerging markets more than any others (Chart 29). In addition, EM have a higher exposure to the growth factor than the Canadian market, a comparative advantage in the current monetary environment.

Finally, some may feel that overweighting emerging markets is a risky decision at this stage. It is true that rising tensions between China and the United States in the run-up to the Presidential elections is a key risk for EM. However, the reality is that by selling Canadian equities in favour of emerging markets, we are shifting assets from the most to the least volatile market year-to-date (in C\$, Chart 30).

29 Emerging markets: big beneficiaries of a weak US dollar...



30 ... and the least volatile region so far in 2020



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General

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