NATIONAL BANK INVESTMENTS

ASSET ALLOCATION STRATEGY

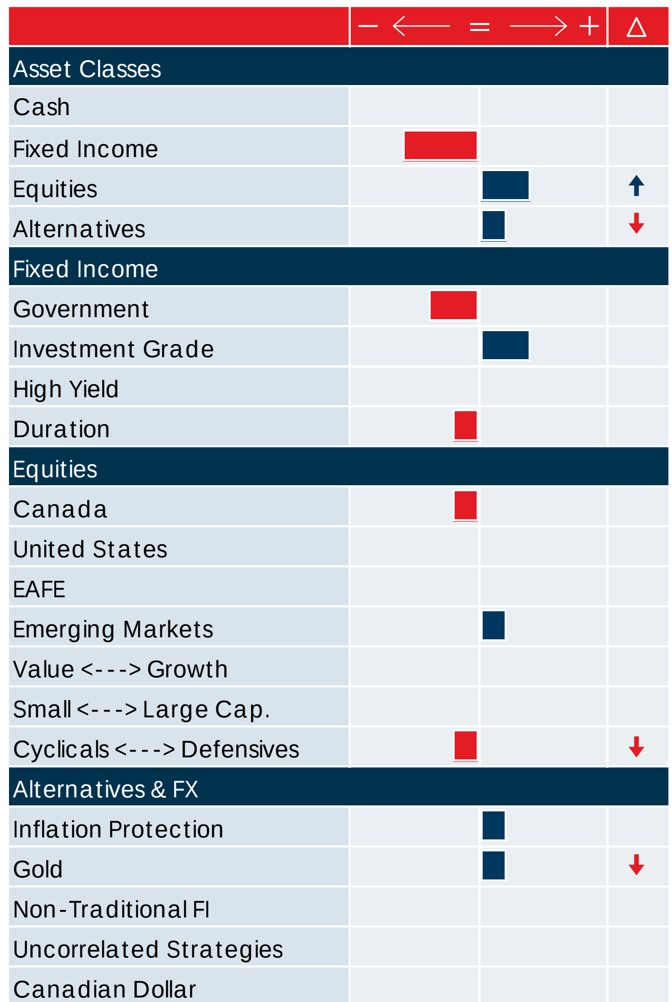
December 2020

Taking Exit 2020, En Route To 2021

Highlights

- The outlook for 2021 is pro risk. With the presidential elections now behind us and, above all, the start of the vaccination operation right ahead of us, we are increasing our allocation in equities one step further. Clearly, the potential for a temporary pullback exists, as bullishness is nearing extreme levels. But, the strength of the pillars driving the current bull market – the main subject of this document – suggests limited downside risks.
- In 2021 we should see the new business cycle carry on, strengthened by the gradual inoculation of the world's population and supported by monetary conditions arguably more accommodative than ever before. Overall, valuations continue to favour stocks, especially when compared to the low expected return on traditional bonds. We recognize that high optimism limits the potential for significant gains in the short term, but it does not seem excessive in light of recent developments. All in all, this background argues in favour of a pro-risk stance, which we plan to gradually increase over the course of the year as opportunities arise.
- Evidently, every year brings surprises that are, by definition, impossible to predict (e.g. a global pandemic). That's why our objective is not to predict the future, but rather to formulate rational hypotheses in light of currently available information. For now, key risks to our baseline scenario are the speed at which COVID-19 immunization can take place, the policies put forward by the new U.S. administration, and the trajectory of inflation.
- For fixed income: after a tumultuous and profitable year, 2021 is looking far less turbulent as long-term rates should remain confined near their current levels. Under these circumstances, corporate credit should outperform, but the asset class overall risk/reward potential is rather poor, especially compared to equity markets.
- For equities: the recent turnaround in market leadership is likely to continue in the coming months, as vaccinations allow for a more broad-based rebound in economic activity, although we do not expect performance spreads to be as dramatic as in 2020. Two strategies could outperform in this environment: the S&P 500 Equally Weighted Index and high-quality dividend-paying companies such as the Dividend Aristocrats. Geographically, emerging markets should be the main beneficiaries of a cyclical recovery.
- For currencies: the path of least resistance for the Greenback is down. As for the Loonie, it is reasonable to assume that it will appreciate modestly over the next 12 months, but we continue to view the currency more as an effective diversification tool.
- For gold: prices should remain supported by highly accommodative monetary conditions and a weaker dollar, but its rising opportunity cost leads us to slightly reduce its target allocation, close to where portfolio drift had naturally brought it.

Table 1 Global Asset Allocation Views



This table is for illustration purposes only. Bars represent the degree of preference of an asset realtive to the maximum deviations allowed from a reference index. The further to the right (left) they are, the more bullish (bearish) our outlook for the asset is. For equity factors/styles, a bar to the right indicates a preference for the factor to the right (e.g. Growth) and vice versa. No bars indicate a neutral view. The column under the delta sign (Δ) displays when our outlook has improved (↑) or worsened (↓) from the previous month. Consult Table 3 for details on the base-case economic scenario underpinning these views and Table 4 to see how they translate into a model

CIO Office

Market Review

Fixed Income

> U.S. 10-year benchmark rates closed November little changed, albeit with much volatility, in a month that contained both a hotly contested Presidential election, as well as the discovery of 3 highly effective COVID-19 vaccines.

> In what was a common theme across asset classes last month, higher-risk products such as investment grade and high-yield bonds outperformed their safer counterparts.

> Having lagged its fixed income cousins for the better part of the year, preferred shares were the best performing asset (5.2%) within the fixed income space in November, while also crossing into positive year-to-date return territory for the first time since February.

Canadian Equities

> Positive vaccine news in November helped buoy equity markets and sparked a rotation toward this year's previously shunned sectors and styles.

> Case in point: the S&P/TSX's Energy and Healthcare sectors – the two worst performers of 2020 – closed out the month at the head of the pack.

> With 10 out of 11 sectors posting gains over the period, November marked a resurgence to positive returns this year for the Canadian equity market.

U.S. Equities

> A feat rarely experienced over the past year, every sector in the S&P 500 posted gains this past month.

> Furthermore, the Index recorded multiple fresh highs throughout the month, in what ended up as its greatest monthly performance since April.

> In similar fashion to its Northern cousin, cyclical and value-oriented sectors tended to outperform their counterparts last month, a phenomenon clearly demonstrated by the Energy (28%), Financials (16%), and Industrials (17%) sectors concluding the period with podium places.

Commodities

> Positive developments in the fight against COVID helped lift energy prices as well, with the WTI gaining a whooping 26% over the period helping it to break out of its recent range.

> Meanwhile, the price of gold slipped last month, as the lustrous metal suffered its worst monthly return (-5.7%) in just over 4 years.

Foreign Exchange

> The Greenback had fallen to its lowest level since April 2018 by the end of last month, weighed down by easy monetary policy and a risk-on mood from investors.

> USD weakness translated into Loonie strength as well, with the Canadian dollar also rising to its pre-pandemic levels.

Table 2 Market Total Returns

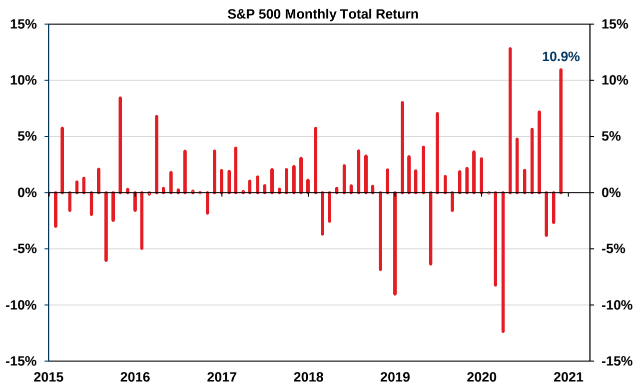
Asset Classes	November	YTD	12 months
Cash (3-month T-bills)	0.0%	0.8%	1.0%
Bonds (FTSE CA Ovr. Univ.)	1.0%	8.3%	7.0%
FTSE CA Short term	0.2%	5.0%	4.9%
FTSE CA Mid term	0.5%	9.4%	8.2%
FTSE CA Long term	2.4%	11.5%	8.7%
FTSE CA Government	0.8%	8.4%	6.9%
Federal	0.2%	7.2%	6.1%
Provincial	1.3%	9.4%	7.5%
Municipal	1.1%	9.6%	8.0%
FTSE CA Corporate	1.7%	7.9%	7.4%
AA+	0.5%	6.0%	5.8%
BBB	1.9%	8.3%	7.8%
BoAML Inv. Grade ($US)	2.7%	9.3%	9.6%
BoAML High-Yield ($US)	4.0%	4.2%	6.4%
Preferred Shares	5.2%	3.7%	6.2%
Canadian Equities (S&P/TSX)	10.6%	3.8%	4.3%
Energy	19.5%	-27.0%	-22.4%
Industrials	7.8%	13.8%	14.3%
Financials	16.4%	-0.2%	-2.7%
Materials	-4.7%	17.5%	23.2%
Utilities	5.9%	14.4%	14.3%
Cons. Disc	14.6%	10.7%	6.9%
Cons. Staples	2.6%	4.9%	-0.3%
Healthcare	35.1%	-14.1%	-12.9%
IT	14.4%	75.3%	80.8%
Comm. Svc.	7.6%	-3.1%	-4.5%
REITs	13.1%	-6.3%	-8.6%
S&P/TSX Small Cap	17.6%	6.7%	12.4%
US Equities (S&P500 USD)	10.9%	14.0%	17.5%
Energy	28.0%	-36.5%	-32.6%
Industrials	16.0%	9.7%	9.7%
Financials	16.9%	-7.5%	-5.0%
Materials	12.5%	17.7%	21.3%
Utilities	0.7%	-0.2%	3.2%
Cons. Disc	8.6%	30.0%	33.7%
Cons. Staples	7.5%	8.8%	11.4%
Healthcare	7.9%	9.2%	13.1%
IT	11.4%	36.1%	42.2%
Comm. Svc.	9.6%	19.9%	22.3%
REITs	7.0%	-3.6%	-2.3%
Russell 2000 (USD)	18.3%	9.1%	12.0%
World Eq. (MSCI ACWI)	12.4%	11.6%	15.6%
MSCI EAFE (USD)	15.5%	3.5%	6.8%
MSCI EM (USD)	9.3%	10.5%	18.8%
Commodities (CRB index)	10.6%	-13.5%	-8.9%
WTI Oil (US$/barrel)	26.0%	-25.8%	-17.8%
Gold (US$/ounce)	-5.7%	16.7%	21.4%
Copper (US$/tonne)	12.8%	23.1%	29.5%
Forex (DXY - US Dollar index)	-2.3%	-4.7%	-6.5%
USD per EUR	2.7%	6.6%	8.5%
CAD per USD	-2.4%	0.1%	-2.1%

CIO Office (data via Refinitiv) 2020-11-30

Taking Exit 2020…

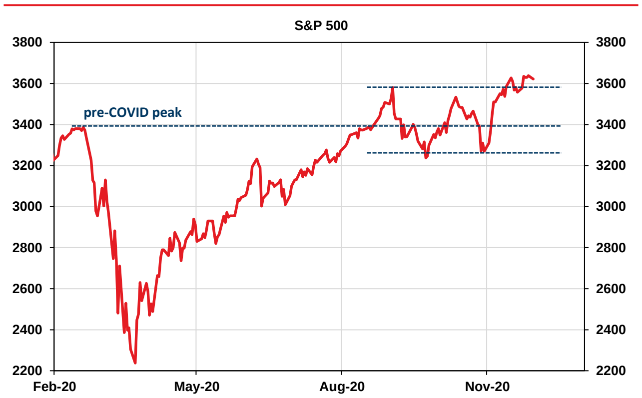
With only four weeks left before officially closing the books on an eventful 2020, U.S. equity markets posted their best monthly performance since April (Chart 1) to finish the period near an all-time high (Chart 2) as two major sources of uncertainty eased in November.

1 Sharp rebound for stock prices in November…



CIO Office (data via Refinitiv).

2 … after 3 months of confinement near the pre-COVID peak

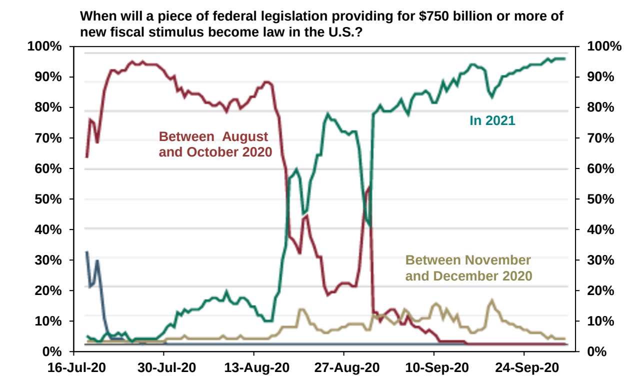


CIO Office (data via Refinitiv).

1) The U.S. elections' outcome. With President-elect Biden and a renewed Republican majority in the Senate,[1] the stock market can carry on its march knowing that U.S. foreign policy (and virtually everything that goes through the White House) will soon be much more predictable than under the current administration. In addition, without Senate control, Democrats are unlikely to succeed in raising corporate taxes as they had envisioned, another positive from a stock market point of view.

On the other hand, political partisanship surrounding the next economic relief bill (and virtually every other bill that passes through the U.S. Congress) will also likely persist, effectively limiting its size and delaying its passage. Fortunately, an in-depth review of U.S. household disposable income conducted by our colleagues at NBF Economics and Strategy shows that the lack of new fiscal measures for another two months should not prevent Americans from maintaining a reasonable level of consumption and would therefore not be catastrophic.[2] In the meantime, Congress must still agree on the 2021 Federal budget before December 11 in order to avoid a government shutdown. Technically, some stimulus measures could be voted on at that time, especially if there is a sense of urgency coming from the imposition of new COVID-19 containment measures. But those odds aren't great (Chart 3).

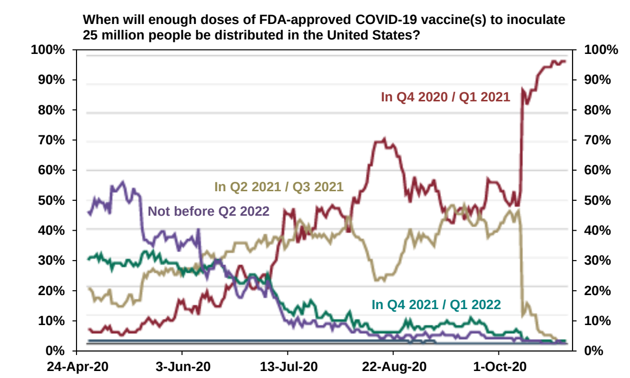
3 **Fiscal stimulus will (in all likelihood) have to wait…**



Source: https://goodjudgment.com/ En date du 30 novembre 2020.

2) The second source of uncertainty that dissipated in November is by far the most important one: how effective and when would COVID-19 vaccines be ready for distribution. The logistics are still being worked out, but there is now little doubt that a significant percentage of the population will be vaccinated by the end of the first quarter of 2021, a scenario that was hardly conceivable just a few months ago (Chart 4).

4 **… but the wait for a vaccine is coming to an end**



Source: https://goodjudgment.com/ As of November 30, 2020.

This turn of events is consistent with our optimistic scenario, whereas our base-case scenario expected widespread vaccinations only to begin around mid-2021. Consequently, just as we took a first step toward an equity overweight in June when the Jobs Report allowed us to conclude the recession was over, we are now increasing our equity allocation a second

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[1] The Senate's outcome will officially be determined on January 5, following Georgia's runoff elections, but Republicans are unlikely to lose their majority.

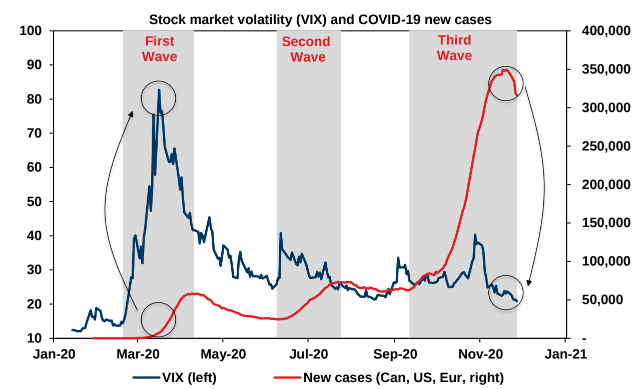
[2] See: Can the U.S. afford to wait until January for another round of stimulus?

time, knowing that the days of COVID-19 are now numbered. For portfolios containing only traditional assets, this change is implemented through a reduction in our bond allocation. For portfolios with alternative assets, we are financing this increase via a reduction in gold (see the commodities section for more details).

Clearly, the risk of a temporary pullback still exists, as bullishness is nearing extreme levels. However, not only is the timing of this potential retreat impossible to predict, but its downside risk remains limited by two important cornerstones of the current bull market: ultra-accommodative monetary conditions and a sustained recovery in economic growth. As we have been saying since summer, this is indeed what has happened in the last few months, and it is even more true now that several highly effective vaccines are on the cusp of being distributed to millions.

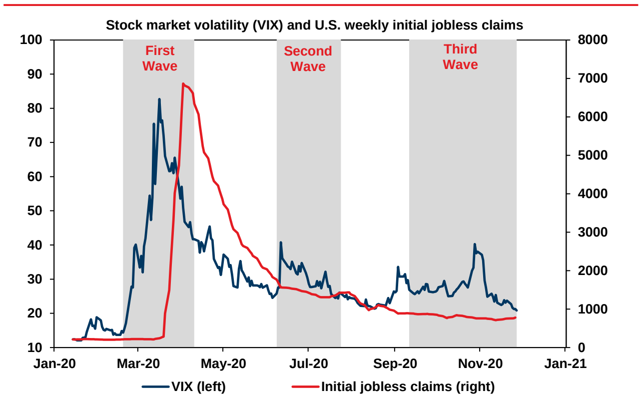
In practice, this means that markets should remain relatively stoic in the face of the likely sustained increase in new COVID cases this winter (Chart 5) and in anticipation of a sustained economic recovery just beyond the horizon (Chart 6).

5 Markets are no longer so afraid of COVID...



CIO Office (data via Refinitiv, Johns Hopkins University).

6 **... having their eyes on the economic horizon**



CIO Office (data via Refinitiv, Johns Hopkins University).

Speaking of horizons, we dedicate the rest of this publication to presenting our outlook for 2021. For the third consecutive year, we begin with a concise review of the main pillars guiding our asset allocation decisions: (1) Cyclical conditions, (2) Monetary conditions, (3) Valuations, and (4) Sentiment. We then follow up by briefly diving into specific asset class views.

Evidently, every year brings surprises that are, by definition, impossible to predict. In 2020, it turns out that was a global pandemic (let's hope 2021 will have more mercy!). Our objective is not to predict the future, but rather to formulate rational hypotheses in light of currently available information. We hope that our publications have helped you navigate this exceptional year. Season's greetings and happy reading!

~ Louis Lajoie

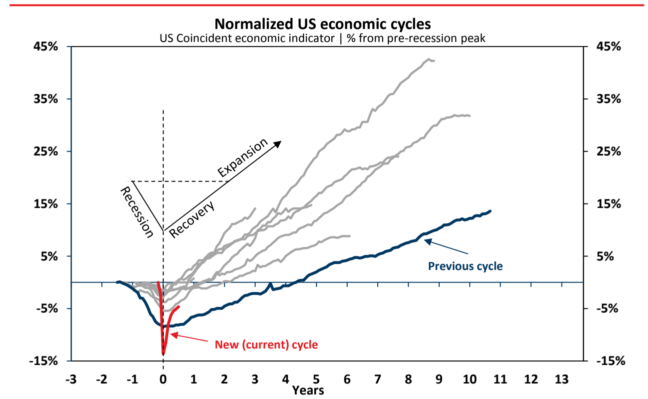
... En Route To 2021

In summary, 2021 should see the new business cycle carry on, strengthened by the gradual inoculation of the world's population and supported by monetary conditions arguably more accommodative than ever before. Overall, valuations continue to favour stocks, especially when compared to the low expected return on traditional bonds. We recognize that high optimism limits the potential for significant gains in the short term, but we do not see this as a major threat as it does not seem excessive following recent developments. In terms of key risks to our baseline scenario, we will need to monitor the speed at which COVID-19 immunization occurs, as well as the trajectory of inflation and the policies put forward by the new U.S. administration. All in all, this background argues in favour of a pro-risk stance, which we plan to gradually increase over the course of the year as opportunities arise.

1. Cyclical Conditions

The latest set of economic data is unequivocal. We are at the beginning of a new business cycle that started last May and is, therefore, only 7 months old. The average lifespan of an economic cycle since 1960 has been 7 years, the last one having lasted 11 years (Chart 7).

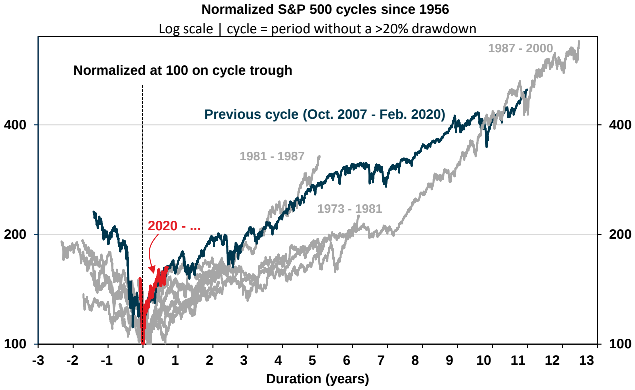
7 **We are early in a new business cycle...**



CIO Office (data via Refinitiv).

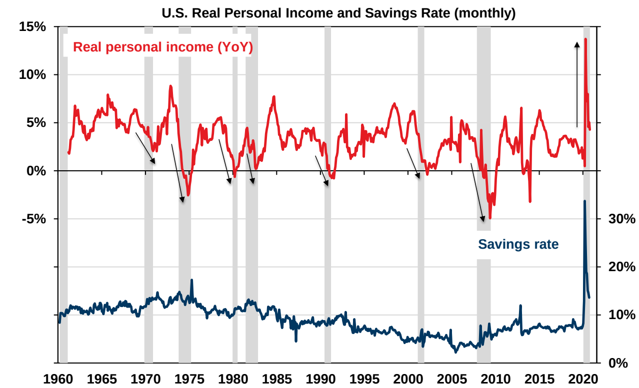
As a general rule, bull markets (a period without a downturn of more than 20%) tend to continue as long as the economy keeps expanding. This suggests that the stock market should remain firmly anchored in its upward trend in 2021. The average lifespan of an equity market cycle since 1960 has been 6 years, with the last one also lasting 11 years (Chart 8, next page).

8 ... and bull market



CIO Office (data via Refinitiv).

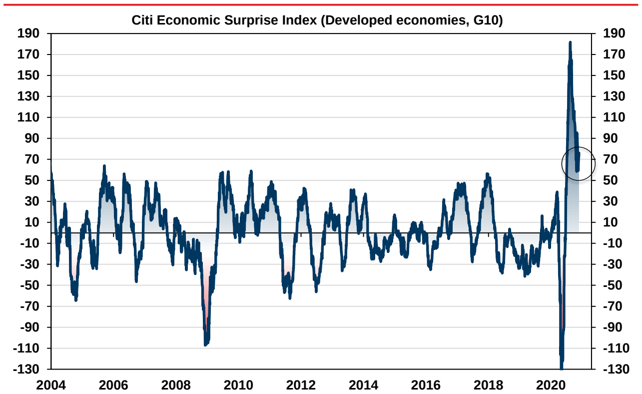
10 ... reflecting an unprecedented fiscal policy response?



CIO Office (data via Refinitiv).

This does not mean that the economic (and, therefore, stock market) recovery is immune to any potential setbacks. A first key risk for 2021 concerns the speed at which the inoculation of a large part of the world's population can take place without further waves of contagion force governments to maintain or increase containment measures. It should be noted, however, that the global economy is already demonstrating considerable resilience despite the persistence of COVID in recent months. This is indeed evidenced by the Economic Surprise Index of the G10 countries, which remains very strong, although the bar is getting higher and higher and, therefore, we should at least expect stabilization in this respect (Chart 9).

9 Spectacular economic resilience...

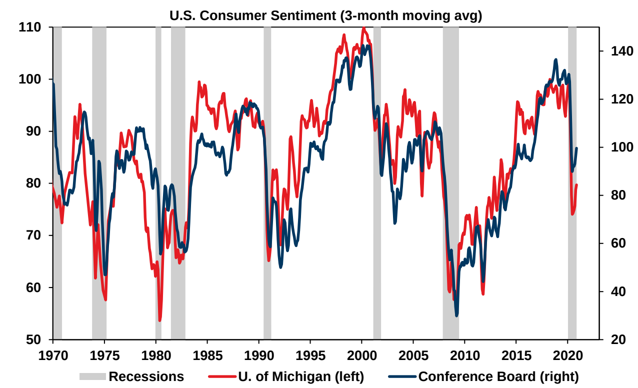


CIO Office (data via Refinitiv).

One reason behind this impressive resilience is presumably the unsuspected impact of fiscal stimulus that was implemented early in the crisis. It significantly strengthened households' disposable income who saved a large portion of it (Chart 10), an unprecedented situation in times of recession.

Thus, in spite of Congress' laxity, U.S. households managed to maintain a healthy level of consumption over the last few months, likely by drawing on these savings, among other things. All evidence suggests these excess savings are likely to help feed further economic growth in 2021, insofar as better control of COVID-19 will ultimately allow for a permanent economic reopening and an increase in consumer confidence (Chart 11).

11 Consumer sentiment will be key in 2021

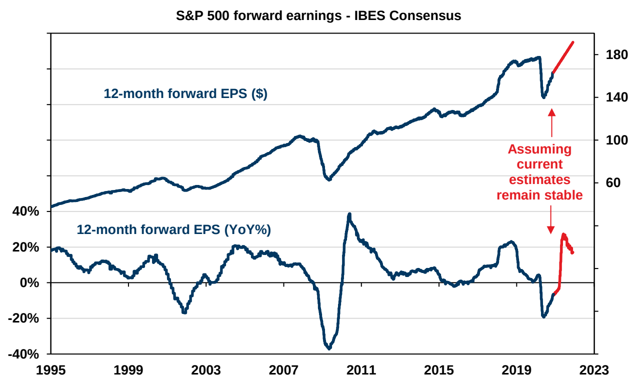


CIO Office (data via Refinitiv).

Against this background, a strong recovery in corporate earnings should act as the main driver of stock market returns in 2021. Currently, analysts' forecasts project growth of over 20% for S&P 500's 12-month earnings. This is similar to what was seen in the aftermath of the recession in the early 2000s and lower than the post-financial crisis recovery, the latter being magnified, however, by a larger base effect (Chart 12, next page).

Some may notice on Chart 12 that 2018 was also marked by earnings growth of around 20%, which did not prevent the stock market from ending the year down -4.4% following a sharp downturn in the fourth quarter. Though it should be remembered that the main trigger for this drop was the premature tightening of monetary conditions by the Federal Reserve, which was then at its fourth rate-hike of the year. As you will see under the next point, we are light-years away from this kind of monetary backdrop.

12 An upturn in corporate earnings is looming

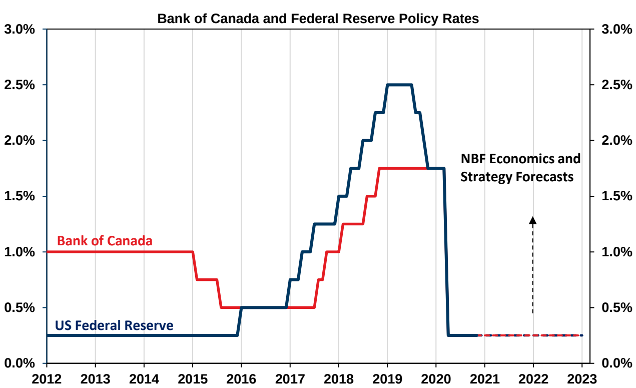


CIO Office (data via Refinitiv).

2. Monetary Conditions

Central banks' intentions are clear: maintain accommodative monetary conditions for as long as it takes to ensure a full economic recovery. In concrete terms, this means we should not expect to see any rate hikes on either side of the border for (at least) the next two years (Chart 13).

13 The Fed and BoC should keep their rates near zero...

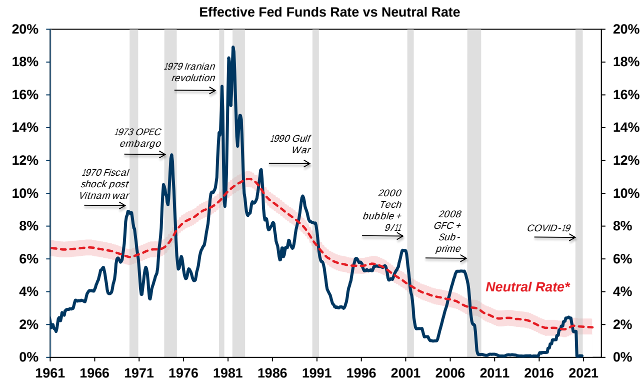


CIO Office (data via Refinitiv, NBF Economics & Strategy).

This is a powerful message for the economy and, consequently, equity markets. Let's recall that each of the last 7 recessions between 1960 and 2009 was preceded by a period when interest rates had been increased above neutral. That's why we often mention that the recession recipe is (1) restrictive monetary conditions + (2) exogenous shock. We came very close to this in 2018 when the Fed was raising rates in the middle of a trade war. In 2020, the shock of a global pandemic the likes of which hadn't been seen in 100 years forced governments to lock down their country's economies, thereby triggering a recession that no monetary policy could have fully countered. Of course, 2021 will have its surprises but they are unlikely to come from central banks, and we can reasonably expect them to be less dramatic than what we have just experienced (Chart 14).

In addition, the change in the Federal Reserve's inflation reaction function formalized this summer was, in our opinion, a

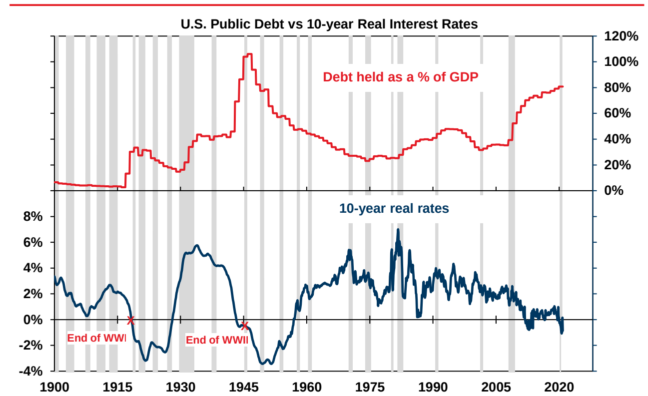
14 ... to ensure accommodative monetary conditions...



CIO Office (data via Refinitiv). *Estimates of the baseline model described in "Measuring the Natural rate of Interest," by Thomas Laubach and John C. Williams + last ten year average core PCE inflation +/ - 50 basis points.

major event of 2020. Since the Volcker-era in the early 1980s, the Fed has generally been more concerned about excessive inflation than the lack thereof. Today, policymakers tell us they want to see inflation moderately above target for a sustained period of time before even considering raising rates. Simply put, the bar for future rate hikes is higher now than at any time in the past 40 years. This change in "philosophy" was already being discussed in 2019. But, with the substantial government indebtedness incurred in fighting the war against COVID-19, there is little doubt that real rates will remain negative for several years, helping to deflate the debt burden. This is a playbook similar to the one observed following the First and Second World Wars (Chart 15).

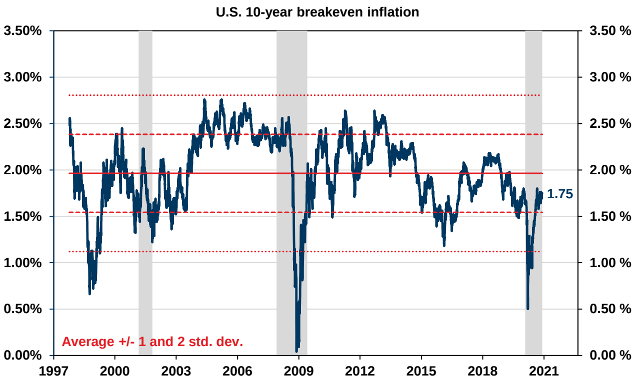
15 ... similar to the post-war era(s)



CIO Office (data via Refinitiv, CBO).

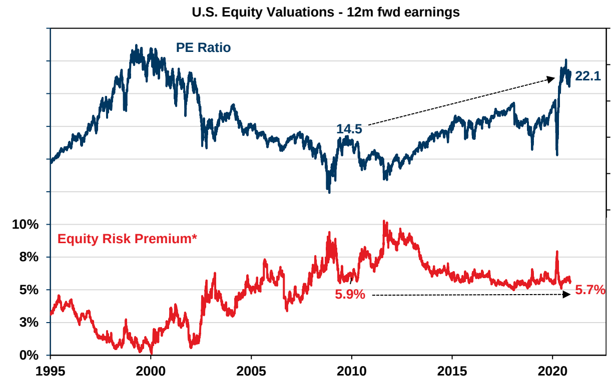
All of this means that the path of inflation (and inflation expectations) – a second key risk for 2021 – will have to be monitored closely. Why? Because too little inflation would mean failure of current monetary policies aimed at bringing it closer to target. Conversely, too much inflation would likely compel central banks to raise rates at the risk of undermining the economy. For now, the most likely scenario is gradual recovery of inflation expectations at slightly above 2% (Chart 16, next page).

16 Keeping an eye on inflation in 2021 (and beyond)



CIO Office (data via Refinitiv).

18 ... but the advantage is to equities in the medium term...

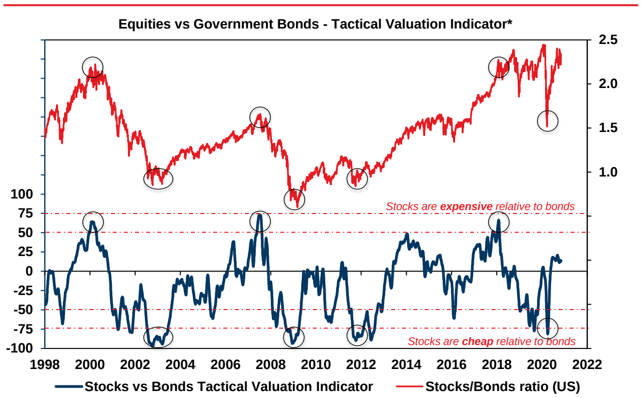


CIO Office (data via Refinitiv). *Inverse of the P/E ratio minus 10-year rate minus 10-year CPI inflation swap.

3. Valuations
Bargains are scarce when we look at absolute valuations across multiple asset classes. However, as asset allocators, our focus is on relative valuations and, overall, the edge remains in favour of risk assets.

Over the shorter term, our metric of choice is our own stock/bond tactical valuation indicator. Historically, this indicator has been rather successful at signalling important market turning points. It is currently close to neutral (Chart 17).

17 Short-term valuations: no major opportunities...

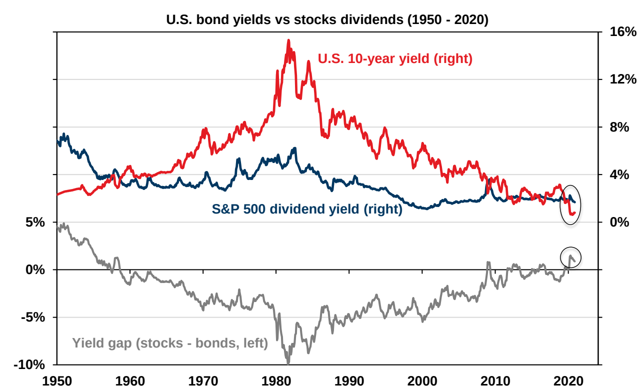


CIO Office (data via Refinitiv). *Average rolling percentile rank spread between global equities PE ratios and global government bond yields.

In the medium term, the valuation measure we favour is the equity risk premium. It allows the traditional price-earnings ratio to account for the level of interest rates. Conclusion: Despite the fact that the S&P 500 is trading at 22x forward earnings – close to a 20-year high – the equity risk premium is roughly where it was at the same point in the previous stock market cycle (December 2009), and far from the "irrational exuberance" of the early 2000s. This gives the advantage to stocks (Chart 18).

In the longer term, a look at the dividend yield of equities relative to the yield on government bonds is even more revealing. The spread between these two figures has not been this much in favour of equities since the late 1950s. Granted, we have recently had brief episodes where the gap was not far from its current level (2009, 2012, 2016), but the difference today is that this rare situation could persist in light of the current monetary backdrop (Chart 19). Could this prompt a number of investors looking for decent returns to migrate from the bond market to the stock market on a strategic basis? This is certainly a theme we suspect will gain popularity in 2021.

19 **... and long term**



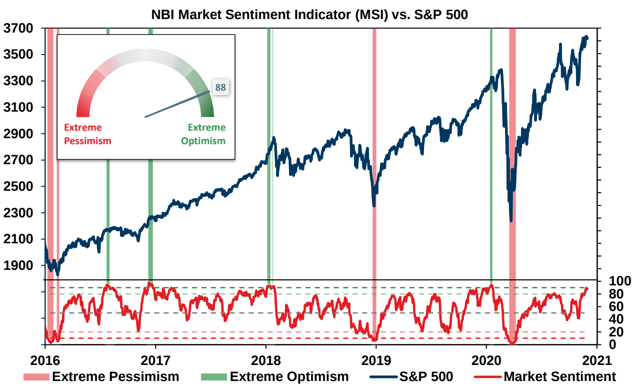
CIO Office (data via Robert Shiller).

4. Sentiment
The flood of good news in recent weeks has, unsurprisingly, resulted in a sharp increase in investor optimism. This is reflected in our market sentiment indicator (Chart 20, next page).

In our view, this undoubtedly leaves the market exposed to a modest pullback in the short term, predicated upon the arrival of bad news as mentioned in our introduction. This is why we favour a gradual increase in our equity allocation as opposed to proceeding with larger scale changes. That said, two points should be emphasized. First, it is only when our indicator reaches an extreme level of optimism (>90) that the potential for a downturn is more likely. We are very near, but not yet there (Chart 21, next page).

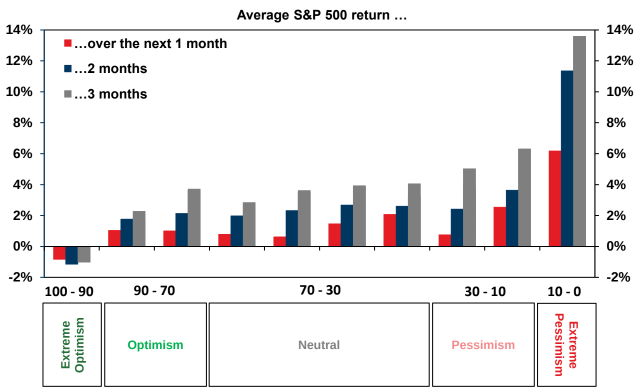
Secondly, and most importantly, it is essential to put this strictly technical indicator into context. The good news behind this

20 Optimism is high...



CIO Office (data via Refinitiv, Bloomberg).

21 ... which *technically* limits upside potential in the short term



CIO Office (data via Refinitiv). Data since January 1st 2009.

optimism is not anodyne. We recently learned that the exceptional research efforts of the global medical community have led to the discovery of not just one, but 3 separate vaccines for the world's worst pandemic in 100 years – and this, at a much faster pace than originally anticipated. Moreover, the steady drum of political theatre and policy volatility of the last 4 years is set to dial down under President Biden, accompanied by Janet Yellen as Treasury Secretary, a highly respected figure who portents a much-needed optimal cooperation with the Federal Reserve. In the meantime, the majority of economic data continues to prove stronger than expected. If our sentiment indicator was not signalling some form of optimism given these circumstances, it would surely be broken.

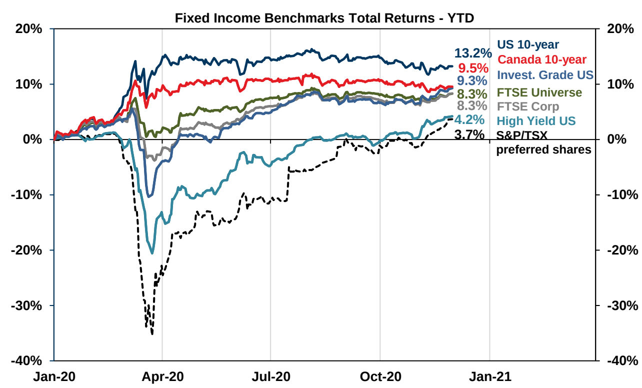
To be clear, Biden's arrival in office does not mean that U.S. politics will suddenly become a calm, quiet river. While a Republican Senate majority greatly limits the potential for sweeping legislative reforms, many questions remain. Hence why we mark political uncertainty is a third key risk for 2021. How significant will the fiscal stimulus package be? To what extent will Biden succeed in advancing his agenda and reversing that of his predecessor through executive orders? And, most importantly, how will his administration handle U.S.-China relations, knowing that maintaining a firm stance is a rare subject for which there is strong bipartisan agreement? For a detailed analysis on this front, see the latest report – *The road ahead for the Biden administration*[3] – from our colleague Angelos Katsoras, Geopolitical Analyst at NBF.

Now that we have reviewed the main pillars of asset allocation underpinning our current positioning, what can we expect within asset classes? This is what we'll discuss in the following sections.

Fixed Income: From the Rockies to the Prairies

After a tumultuous and generally profitable year for fixed-income assets (Chart 22), 2021 is looking far less turbulent.

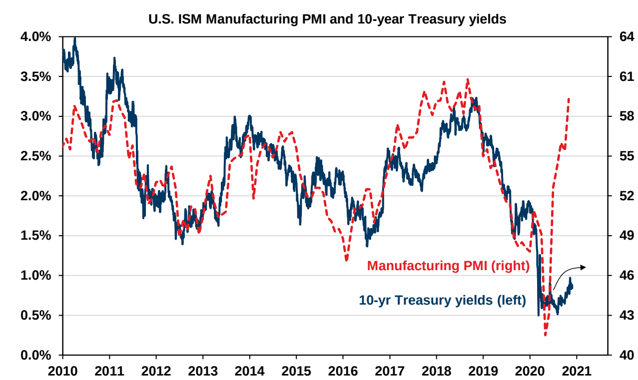
22 From the Rockies...



CIO Office (data via Refinitiv).

Despite upward pressure stemming from the ongoing economic recovery, long-term rates should remain confined near their current levels – consistent with central banks' commitment to ensure highly accommodative monetary conditions (Chart 23).

23 ... to the Prairies...



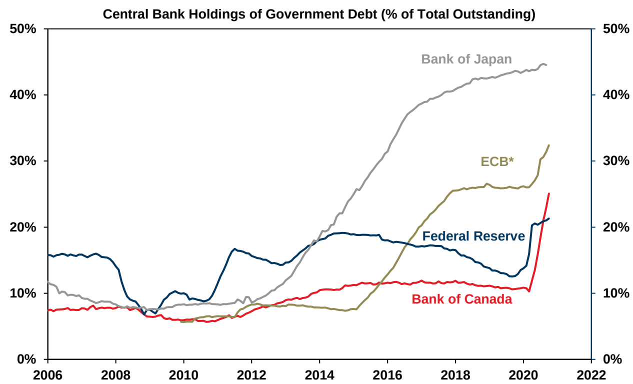
CIO Office (data via Refinitiv).

If central banks' guidance alone fails to contain these upward pressures, monetary authorities will likely expand their asset purchase program as to ensure financial market stability. That's

[3] See : The road ahead for the Biden administration

what was done in the face of the massive budget deficits in 2020, and it is likely to remain their primary tool for years to come (Chart 24).

24 ... with central banks at the wheel



CIO Office (data via Refinitiv, BoJ, ECB, FRED). *Includes debt held by the European Central Bank and other central banks of the eurosystem.

In practice, this implies a poor risk/return profile for fixed-income assets and, especially, government debt. Case in point: a sensitivity analysis shows that a mere 20-basis-point increase would see all 10-year public debt in the red in 2021, while a maximum risk-off scenario would only mean mid-single-digit returns for the most part (Chart 25).

25 **Poor risk/return profile for government debt...**

Expected 1-year Total Return from Interest Rate Changes

Rate Change	U.S. 10-year Bond	Canada 10-year Bond	Germany 10-year Bond	Japan 10-year Bond	FTSE Can. Universe*
100bps	-7.8%	-7.8%	-10.0%	-9.3%	-6.6%
80bps	-5.9%	-6.0%	-8.0%	-7.4%	-5.0%
60bps	-4.1%	-4.2%	-6.1%	-5.5%	-3.3%
40bps	-2.2%	-2.5%	-4.1%	-3.5%	-1.7%
20bps	-0.3%	-0.7%	-2.1%	-1.6%	0.0%
0bps	1.5%	1.1%	-0.2%	0.4%	1.6%
-20bps	3.4%	2.9%	1.8%	2.3%	3.3%
-40bps	5.3%	4.7%	3.7%	4.3%	5.0%
-60bps	7.1%	6.5%	5.7%	6.2%	6.6%
-80bps	9.0%	8.3%	7.6%	8.2%	8.3%
-100bps	10.9%	10.1%	9.6%	10.1%	9.9%

The blue line limits what we can reasonably expect in a maximum risk aversion scenario (US and CA 10-yr yields near 0%, Germany near -1%, Japan near -0.5%).

CIO office (data via Refinitiv, iShares, as of November 27, 2020). Total Return is measured as the sum of Starting Yield, Roll Yield, and Rate Change impact (assuming only parallel shifts in the yield curve). *For IG bonds, which represent approximately 30% of the index, we assume no change in their spread against government securities.

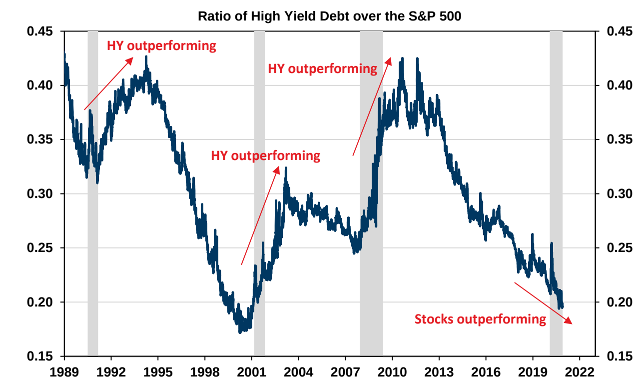
Under these circumstances, corporate credit should outperform this year, considering that a sustained recovery in growth should at least allow spreads to remain close to their current levels or to even contract further (Chart 26).

For our part, we prefer to stick to investment-grade credit for two main reasons. First, because high-yield spreads are far from signalling a bargain. But secondly, and more importantly, because we prefer to deploy more of our risk budget toward the stock market where the risk/return profile seems more compelling. In fact, unlike the last three recessions, the stock market has outperformed corporate debt since the start of the recovery, and we see this trend continuing in 2021 (Chart 27).

26 ... giving an edge to corporate credit...

CIO Office (data via Refinitiv).

27 ... but mainly to equities

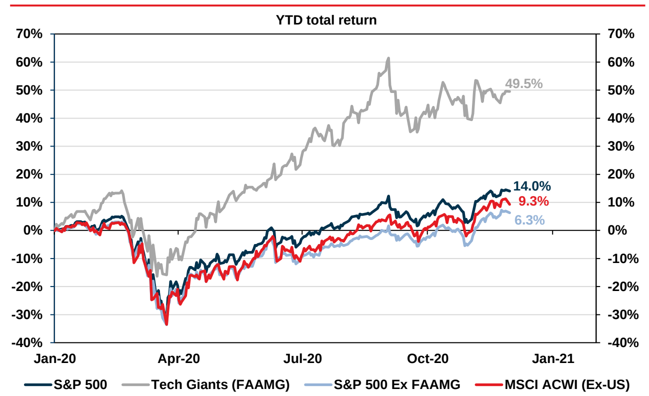


CIO Office (data via Refinitiv).

Equities: Change of Driver

The pandemic backdrop gave rise to a total domination of defensive, large-cap, high-growth stocks in 2020. For instance, the 5 tech giants are responsible for more than half of the S&P 500's annual performance (Chart 28). We don't expect them to do poorly in 2021, but they should nonetheless yield their place at the top of the podium to others.

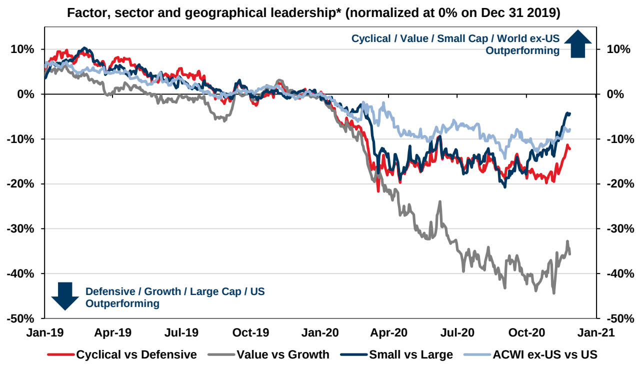
28 Large-cap technology dominated in 2020...



CIO Office (data via Refinitiv).

Looking under the market's hood, we have seen for the past few months that the big winners of 2020 have already been losing ground against laggards, though these relative trends have been highly volatile (Chart 29).

29 … but the wind is turning…



CIO Office (data via Refinitiv).

In our view, this turnaround is likely to continue over the coming months, as vaccinations allow for a more broad-based rebound in economic activity. That said, we do not expect performance spreads to be as dramatic as in 2020, notably because interest rates – an important macroeconomic factor for stock market leadership (Chart 30) – are unlikely to move as abruptly as they did in 2020.

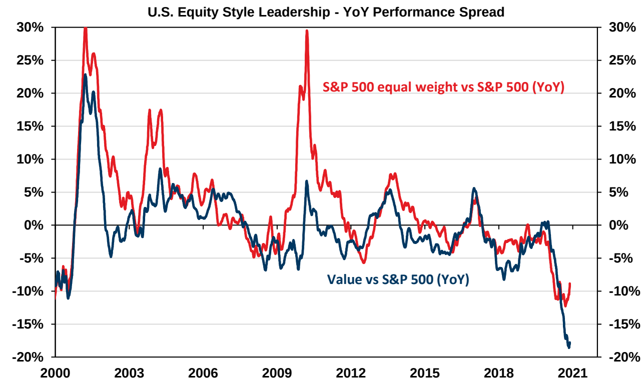
30 … though it's unlikely to be as strong as this year

CIO Office (data via Refinitiv). *Ratio between average of S&P 500 Value & Cyclical sectors (Financials, Energy, Materials, Cons. Discr., Industrials, Real Estate) and Growth & Defensive sectors (Tech, Health care, Comm svs, Utilities, Staples)

One position that has done well lately and that we see continuing to outperform is the S&P 500 Equally Weighted Index. This strategy naturally offers diversified exposure to all three trends illustrated in Chart 29, namely the more cyclical, typically value-style sectors and (relatively) smaller capitalizations. Interestingly enough, it has historically performed either equally to or better than the more concentrated value strategies (Chart 31).

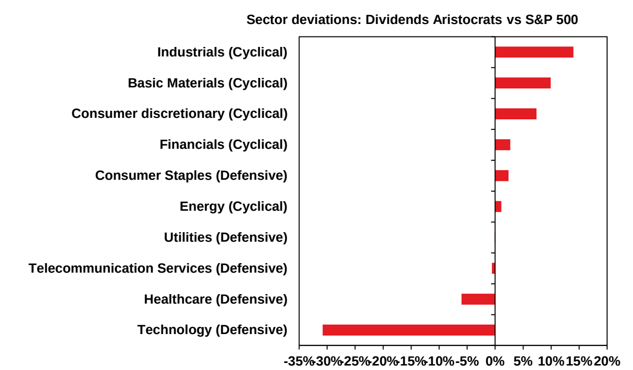
A second strategy we favour for 2021 is the "Dividend Aristocrats" Index, i.e. quality companies that have paid and grown their dividends for a minimum of 25 consecutive years. In addition to yielding more (~2.5%) than the S&P 500 (~1.6%), this strategy offers sector allocation geared to do well during a cyclical upturn in economic activity (Chart 32).

31 Equally weighted index: well positioned for 2021…



CIO Office (data via Refinitiv).

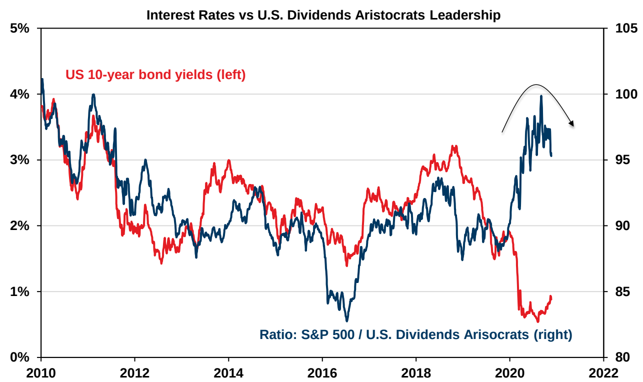
32 … much like *dividend aristocrats*…



CIO Office (data via Thomson Reuters Elkon). As of October 31, 2020.

Historically, dividend aristocrats have tended to out(under)perform at the whim of interest rates. This is logical, since the lower (higher) the yields are that bonds offer, the higher (lower) the attractiveness is of companies that can ensure strong dividend yields. However, in 2020, investors' only concern was seemingly to find pandemic-immune companies, so this relationship completely broke down (Chart 33). We believe this rupture to only be temporary. The chronic lack of assets generating reasonable levels of income is an issue that the monetary response to the pandemic has aggravated and it is here to stay. Consequently, these companies should gain popularity and not necessarily only among equity investors.

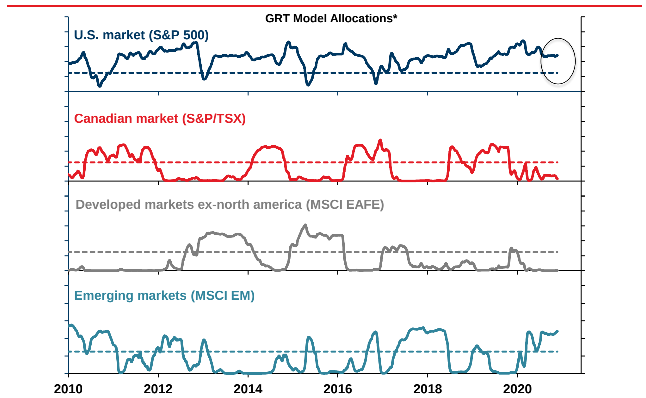
33 ... especially so in today's low interest rate environment



CIO Office (data via Refinitiv).

Geographically, we maintain our asset mix unchanged: overweight in emerging markets at the expense of Canada, and neutral in the U.S. and EAFE region. In theory, the S&P 500 should lag in 2021, considering that its sector allocation makes it the most defensive and counter-cyclical of the group. However, it is precisely for this reason that we reduced its allocation from overweight to neutral in early October by buying further EAFE equities. While this change has proven beneficial thus far – the EAFE region is up 10.6% since October 1st, compared to 7.4% for the S&P 500 – we stated at that time that we would wait for a clear signal of leadership transition from our GRT model before making more aggressive changes. This signal has yet to come, but it is something we will be following closely in the coming months (Chart 34).

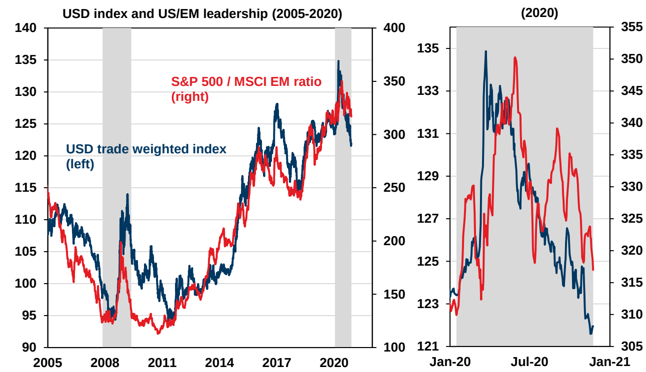
34 GRT model: Not (yet?) convinced of a geographic rotation



CIO Office (data via Refinitiv). *Vs equalweight benchmark.

For now, the region where we have stronger conviction is in emerging markets (EM). Besides a positive signal from our GRT model, EM are generally the main beneficiaries of a cyclical recovery environment featuring depreciation of the U.S. dollar, as we foresee (Chart 35).

35 **A lower USD is emerging markets' best friend**

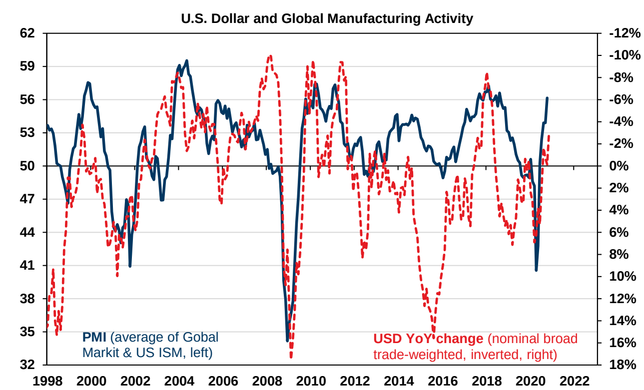


CIO Office (data via Refinitiv).

Currencies: Dollar Heading South

The counter-cyclical properties of the U.S. dollar should play against the currency over the next year, if economic activity continues to pick up in line with our anticipations (Chart 36).

36 **The cyclical recovery is bearish for the USD...**



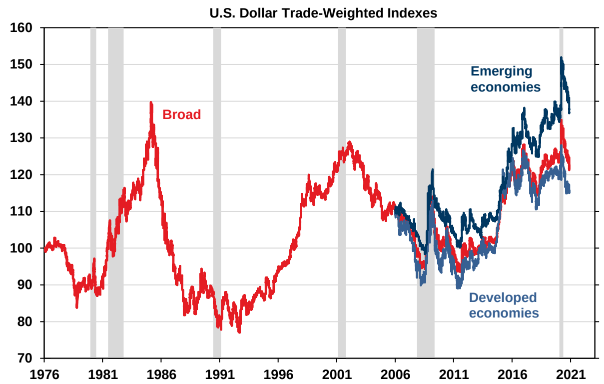
CIO Office (data via Refinitiv).

This has been our message for several months,[4] and has indeed remained the case since then – the trade-weighted U.S. dollar index is down ~4 % since the beginning of August – and all indications are this trend should continue in 2021. Emerging countries, however, have the greatest potential for appreciation against the Greenback, given the growth and interest rate differentials that play greater roles in their favour than in developed nations (Chart 37, next page).

What about the Canadian dollar? In brief, though the currency is already back to its pre-pandemic level, the logical result of the looming economic scenario is that its appreciation should continue. The 12-month target of our colleagues from NBF Economics and Strategy (1.25 USDCAD/0.80 CADUSD) suggests an upside of about 4% over the period (Chart 38, next page).

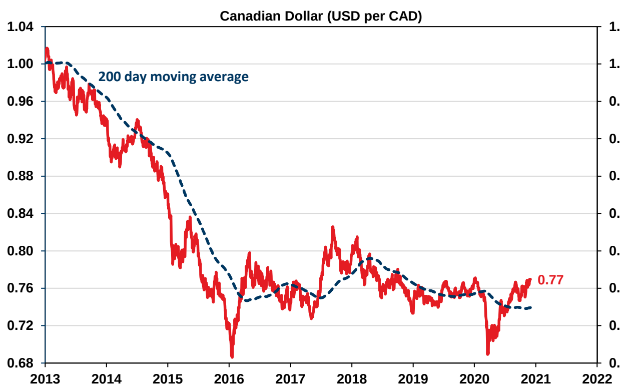
[4] See the currencies section – *Headwind for the Dollar* – of our August 4 asset allocation report for more details.

37 … especially against emerging markets currencies



CIO Office (data via Refinitiv).

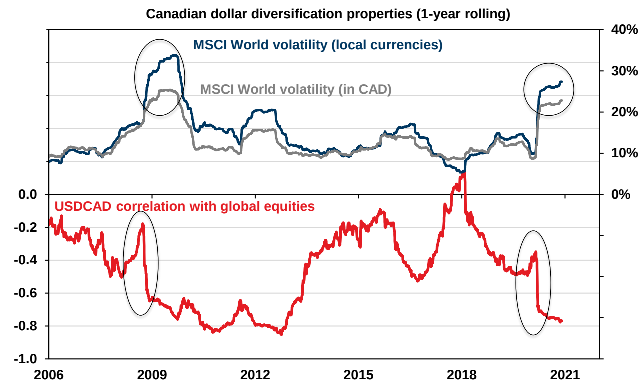
38 The CAD should appreciate slightly…



CIO Office (data via Refinitiv).

So why not hedge foreign-exchange risk of equities? We do not rule out taking a position in this regard at some point in the next few months, but this is not what we promote at this time, and the reason is simple: diversification. In a world where assets offering a negative correlation to equity markets are scarce when needed, the Loonie has demonstrated that it remains an option of choice in this regard. Just as it did during the financial crisis, the our currency played its role to perfection at the worst of the pandemic-induced stock market plunge, as evidenced by the falling correlation coefficient between the two assets and its welcomed impact on volatility (Chart 39).

39 … but it's above all a remarkable diversification tool



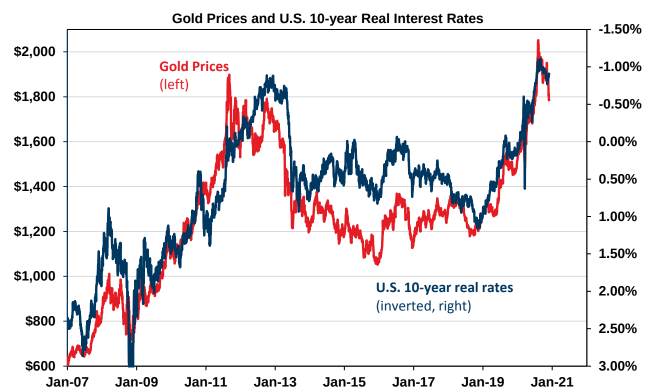
CIO Office (data via Refinitiv).

Commodities: Gold Insurance

Gold prices should remain supported by highly accommodative monetary conditions in 2021, but their upside potential appears more limited following recent developments.

For example, real yields – a key macro factor for gold prices behind most of their ascent in 2020 (Chart 40) – stood relatively unchanged against the cyclical rally in November, about 20 basis points higher than their lows of late August. This suggests that, while this factor should not adversely affect gold, it is also unlikely to carry gold significantly higher, at least in the short term.

40 Real yields are unlikely to weigh on gold prices…

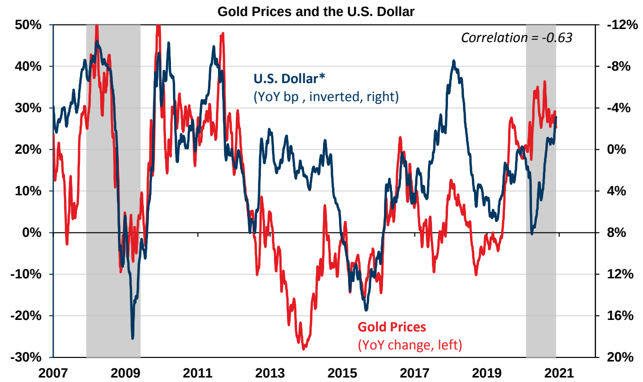


CIO Office (data via Refinitiv).

One other important factor for gold could still take over: the U.S. dollar. As stated in previous publications, gold shares many of the characteristics of currency. As such, the generalized dollar depreciation we expect in 2021 should act as a tailwind for the commodity (Chart 41, next page).

That said, gold's main weakness today may not be directly linked to gold itself, but rather to its opportunity cost. Since portfolio space is constrained, a position in gold – a form of insurance against currency devaluation, inflation, and other unforeseen risks – must come at the expense of other assets. It is precisely this dynamic that we observe by analyzing the

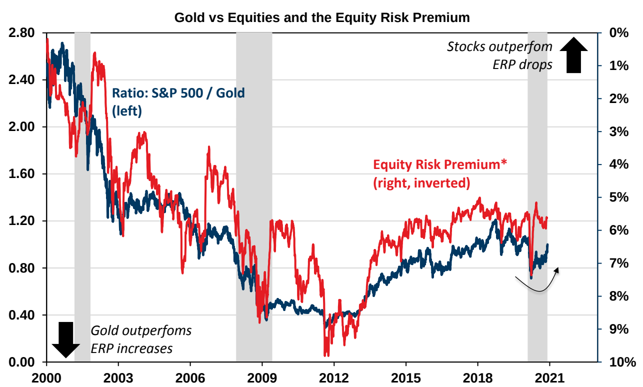
41 **... and a weaker USD should carry it higher...**



CIO Office (data via Refinitiv).

S&P 500/Gold Ratio against the equity risk premium, and this is what most likely explains the precious metal's troubles in November (Chart 42).

42 **... but its opportunity cost is rising**



CIO Office (data via Refinitiv).

Overall, we believe gold still merits its place in a portfolio, but its rising opportunity cost in the face of a year that looks more promising for risky assets leads us to slightly reduce its target allocation, close to where portfolio drift had naturally brought it.

Table 3 Base Case Scenario

Scenario (prob.*)	Key elements and investment implications
Base case (60%)	• The global economy emerges out of a severe but brief recession. The pace of growth remains above the long-term trend but slows down relative to Q3-2020. The rise of COVID-19 cases in some parts of the world and at different times leads to greater dispersion in economic data.
	• Advances in medical research, compliance with best sanitary practices by most people, and the disproportionate economic cost associated with total lockdowns incline governments to adopt a more targeted approach to fighting the pandemic. Progress in vaccine research suggests the start of generalized vaccination in the second half of 2021.
	• Central bank interventions ensure highly accommodative monetary conditions. The majority of developed countries maintain an adequate level of fiscal support. The U.S. Congress extends their fiscal stimulus package after presidential elections.
	• The U.S. electoral backdrop creates a high degree of uncertainty for financial markets, but does not significantly alter the trajectory of the ongoing economic recovery.
	→ **Bond yields remain stable while the U.S. dollar depreciates. Equities remain on an upward trend, but their pace slows down. Leadership across regions remains volatile, emerging markets outperform.**
Bullish (20%)	• The U.S. Congress passes a major fiscal stimulus package before year-end. This facilitates a stronger than expected rebound in economic activity and generates a sharp increase in investors' risk appetite.
	• Unprecedented research efforts led by the global scientific and medical community bear fruit; COVID-19 vaccines are rapidly manufactured and ready for distribution in early 2021.
	→ **Bond yields rise modestly while the U.S. dollar depreciates. Global equities reach new highs. Leadership shifts to small caps, cyclical, emerging markets and EAFE equities.**
Bearish (20%)	• Persistently rising COVID-19 infections and inadequate fiscal responses damage consumer confidence and hinder the recovery.
	• Central banks redouble their efforts, but these prove insufficient in preventing a series of defaults on corporate debt, while upward pressure on the USD further jeopardizes emerging economies.
	→ **Bond yields fall and the U.S. dollar shoots higher. Equities venture near bear market territory. Leadership shifts to government and high-grade bonds. Defensive stocks outperform.**

*CIO Office. Last update: October 1, 2020 (updated quarterly unless an event demands a revision). *Subjective probabilities based on current market conditions and subject to change without notice.*

Table 4 Global Asset Allocation - Model Portfolio Weights (in CAD)

	Benchmark		Model Portfolio				Comments
			Total		Asset Class		
	Total	Asset Class	Allocation	Active Weight	Allocation	Active Weight	
Asset Classes							
Cash	0%	-	0.0%	0.0%	-	-	Early in a new economic cycle, the outlook for equities compares favourably to bond markets, which are showing yields close to an all-time low. Alternatives allow for better control of the total risk of the portfolio and offers protection against a potential recovery in inflation. Overall, this positioning is slightly pro-risk.
Fixed Income	40%	-	32.0%	-8.0%	-	-	
Equities	60%	-	62.0%	2.0%	-	-	
Alternatives	0%	-	6.0%	6.0%	-	-	
Fixed Income							
Government	28%	73%	17.5%	-10.5%	55%	-18.3%	Highly accommodative monetary conditions and a gradual recovery in economic activity should lead corporate bonds to outperform government securities. For risk control purposes, we are sticking to investment grade credit. Treasury yields should remain close to current levels, with inflation expectations exerting only modest upward pressure on interest rates over the cyclical horizon.
Investment Grade	12%	27%	14.5%	2.5%	45%	18.3%	
High Yield	0%	0%	0.0%	0.0%	0%	0.0%	
Duration	*8.4 yrs*	-	*8.0 yrs*	-0.4 yrs	-	-	
Equities							
Canada	21%	35%	20.0%	-1.0%	32%	-2.7%	Geographical mix broadly in line with the recommendations of our GRT model. We expect emerging markets to be the major beneficiaries of the weakening U.S. dollar environment. To diversify against a potential style rotation and add cyclicality, we hold neutral positions in U.S. and EAFE equities, we favour the high-quality (MSCI Quality, 4% weight) dividend-paying (Div. Aristocrats, 4%) companies and the equal weight index (4%) in the U.S.
United States	21%	35%	21.7%	0.7%	35%	0.0%	
EAFE	12%	20%	12.4%	0.4%	20%	0.0%	
Emerging markets	6%	10%	7.9%	1.9%	13%	2.7%	
Alternatives							
Inflation Protection	0%	0%	2.0%	2.0%	33%	33.3%	The macroeconomic environment remains very favourable to gold, with real interest rates likely to trend lower and the U.S. dollar to depreciate. Accordingly, TIPS should outperform their nominal counterparts, in addition to providing more direct inflation protection and little volatility. This asset mix offers low correlation with traditional assets.
Gold	0%	0%	4.0%	4.0%	67%	66.7%	
Non-Traditional FI	0%	0%	0.0%	0.0%	0%	0.0%	
Uncorrelated Strategies	0%	0%	0.0%	0.0%	0%	0.0%	
Foreign Exchange							
Canadian Dollar	61%	-	54.0%	-7.0%	-	-	We do not have a specific view on the Canadian dollar. Our overall portfolio strategy places us overweight in U.S. dollars versus our benchmark, mainly due to our gold position. We maintain this positioning solely because gold in Canadian dollars offers more attractive historical properties from a portfolio construction standpoint.
U.S. Dollar	21%	-	25.7%	4.7%	-	-	
Euro	5%	-	4.7%	0.2%	-	-	
Japanese Yen	3%	-	3.2%	0.1%	-	-	
British Pound	2%	-	1.7%	0.1%	-	-	
Others	9%	-	10.7%	2.0%	-	-	

CIO Office. The fixed income benchmark is 100% FTSE Canada Universe. There are no alternative assets in the benchmark as their inclusion is conditional on improving the risk/return properties of traditional assets (60/40). The amplitude of the color bars under the "Active Weight" columns are proportional to the maximum deviations of the portfolio (+/- 10% for stocks and bonds, +10% in cash, +20% in alternative assets).

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General

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