NATIONAL BANK INVESTMENTS

ASSET ALLOCATION STRATEGY

July 2020

Great Recessions → Great Rebounds → Now What?

Highlights

- Most global equity indices ended an especially volatile month of June slightly higher, allowing the S&P 500 to officially record its best quarter since 1998. It is extremely unusual to observe strong stock market gains in parallel with such an elevated level of volatility (VIX). However, one period similar to what we've just experienced stands out: the initial bounce out of the Great Financial Crisis (GFC). This begs the question: are we in the early days of a new business cycle? And, if so, how does the current situation – referred to as the Great Lockdown – compare to 2009 and what lessons can we learn?
- Judging by the most recent data, it certainly seems that the trough in economic activity is behind us, which technically means that we are indeed early in a new cycle. For instance, U.S. retail sales have already recovered 62% of their decline. Meanwhile, a consensus expectation of 8 million job losses for May turned out to be quite inaccurate, with the country actually adding 2.5 million new jobs over the period.
- If history were to repeat itself, we should expect the upward trend in equity markets – which is so far highly similar to what we saw between March and June 2009 – to carry on in the coming year, although the rally may be due for a break over the summer months.
- Moreover, it is normal for a post-crisis rebound to occur almost entirely via an increase in valuations. If we normalize at current levels, we see that the price-earnings (PE) ratio of the S&P 500 had risen by the equivalent of 6 points in the first 3 months of the 2009 recovery, and by 8 points from its absolute bottom. Today, this multiple has also increased by 8 points since the trough of March 23.
- Nevertheless, stocks are unlikely to be driven any further by valuations. It is now up to corporate earnings to take over as the main contributor to returns. Will the current consensus prove overly optimistic or overly pessimistic? The upcoming earnings season should shed some light on this matter. But, if we look at the example of 2009-10, it seems that there is still potential for upward revisions.
- Now, let's not delude ourselves. While looking back in history is always a good starting point to formulate an outlook, the list of fundamental differences between 2009 and 2020 is long. At the top of it is a pandemic that clearly has not yet had its last say and is, therefore, putting the pace of recovery at risk. Another fundamental difference is that a U.S. Presidential election is due in just 4 months.
- But, in the end, the most important difference between 2009 and 2020 is perhaps the magnitude of actions taken by central banks and fiscal authorities. Their near-perfect coordination will certainly create new challenges, but the fact remains that it's a major tailwind for the ongoing recovery.
- Overall, we now believe this backdrop justifies a modest pro-risk stance. Accordingly, we've taken a first step in favour of equity markets by deploying our excess cash position early in June. Downside risks we mentioned last month have obviously not disappeared, and the context should consequently remain highly volatile. However, most recent economic figures confirmed the recovery is well under way, which therefore brings the balance of risks back in favour of equity markets.

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

- On June 10, the Federal Open Market Committee (FOMC) indicated it would maintain its policy rate near zero until it was confident the economy had "weathered"[1] the ongoing COVID-induced economic shock.
- Following the announcement, longer-term rates both in Canada and the U.S. fell sharply back into their previous months' range.
- Meanwhile, as spreads inched lower toward historical norms following a gradual easing reopening of the American economy, U.S. Investment Grade bonds had their strongest quarterly performance since Q4 2008.

Canadian Equities

- Taking stock of Canadian Equities at the year's halfway point, we find an extremely wide range of performances across sectors.
- A preference for more defensive sectors has helped Materials and Consumer Staples post positive year-to-date returns, while certain sectors such as Real Estate and Energy – more deeply affected by recent lockdowns – remain firmly in the red.

U.S. Equities

- Following an impressive rebound in risk asset prices and valuations in April and May, June saw the S&P 500 take a breather finishing relatively flat, unnerved by a reacceleration in COVID-19 cases in the final weeks of the month.
- Stocks in the Technology and Consumer Discretionary sectors outperformed the more defensive Health and Utilities sectors.

Commodities

- It was one rollercoaster of a quarter for Crude, as the dramatic drop in the price of a barrel of WTI back in April was followed by a surge over the following two months, spurred on by OPEC+ and U.S. production cuts as well as renewed demand from end-users as lockdown measures gradually eased.
- Meanwhile, now trading near an 8-year high, gold remained popular with investors last month, with its recent strength partly attributed to the fall in real rates – a lower opportunity cost of holding it – and a desire to hedge against inflation risk.

Foreign Exchange

- The U.S. Dollar Index remained range-bound throughout June, as a resurgence in local COVID-19 cases highlighted the fragility of investors' risk-on mood this past quarter.
- The Loonie, on the other hand, faced pressure in the final days of the month amidst concerns of a flareup in trade tensions between Canada and its neighbour to the south.

Table 2 Market Total Returns

Asset Classes	June	Q2	YTD
Cash (3-month T-bills)	0.0%	0.1%	0.8%
Bonds (FTSE CA Ovr. Univ.)	**1.7%**	**5.9%**	**7.5%**
FTSE CA Short term	0.5%	2.1%	4.0%
FTSE CA Mid term	1.0%	4.8%	8.3%
FTSE CA Long term	3.5%	11.2%	11.4%
FTSE CA Government	1.4%	5.1%	8.3%
Federal	0.5%	2.3%	7.5%
Provincial	2.1%	7.7%	9.1%
Municipal	2.0%	6.9%	8.1%
FTSE CA Corporate	2.6%	8.1%	5.4%
AA+	1.0%	4.1%	4.4%
BBB	3.0%	9.7%	5.1%
BoAML Inv. Grade ($US)	2.0%	9.3%	4.8%
BoAML High-Yield (USD)	1.0%	9.6%	-4.8%
Preferred Shares	3.9%	15.0%	-11.2%
Canadian Equities (S&P/TSX)	**2.5%**	**17.0%**	**-7.5%**
Energy	-4.6%	10.9%	-30.4%
Industrials	1.5%	13.2%	-3.8%
Financials	3.7%	6.2%	-16.2%
Materials	4.5%	42.0%	15.4%
Utilities	-0.7%	3.8%	-1.7%
Cons. Disc	1.9%	32.8%	-10.8%
Cons. Staples	-0.4%	11.7%	1.3%
Healthcare	-3.5%	9.9%	-30.9%
IT	13.5%	68.3%	62.0%
Comm. Svc.	-2.5%	-1.0%	-9.0%
REITs	3.2%	11.7%	-20.0%
S&P/TSX Small Cap	5.6%	38.5%	-14.3%
US Equities (S&P500 USD)	**2.0%**	**20.5%**	**-3.1%**
Energy	-1.3%	30.5%	-35.3%
Industrials	2.0%	17.0%	-14.6%
Financials	-0.3%	12.2%	-23.6%
Materials	2.2%	26.0%	-6.9%
Utilities	-4.7%	2.7%	-11.1%
Cons. Disc	5.0%	32.9%	7.2%
Cons. Staples	-0.3%	8.1%	-5.7%
Healthcare	-2.4%	13.6%	-0.8%
IT	7.1%	30.5%	15.0%
Comm. Svc.	-0.5%	20.0%	-0.3%
REITs	1.5%	13.2%	-8.5%
Russell 2000 (USD)	3.4%	25.0%	-13.6%
World Eq. (MSCI ACWI)	**3.2%**	**19.4%**	**-6.0%**
MSCI EAFE (USD)	3.4%	15.1%	-11.1%
MSCI EM (USD)	7.4%	18.2%	-9.7%
Commodities (CRB index)	**-1.9%**	**-2.7%**	**-10.3%**
WTI Oil (US$/barrel)	16.5%	91.7%	-35.7%
Gold (US$/ounce)	3.0%	10.6%	17.3%
Copper (US$/tonne)	12.2%	21.6%	-2.3%
Forex (DXY - US Dollar index)	**-1.0%**	**-1.7%**	**1.0%**
USD per EUR	1.0%	2.4%	0.1%
CAD per USD	-1.4%	-3.5%	4.5%

CIO Office (data via Refinitiv) 6/30/2020

[1] FOMC's June 10, 2020 press release

Great Recessions → Great Rebounds → Now What?

Most global equity indices ended the month of June up slightly, allowing the U.S. stock market to officially record its best quarter since 1998. Taken at face value, this generally bodes well for the future, as we mentioned last month (Chart 1).

1 Best quarter since 1998 for the U.S. stock market...

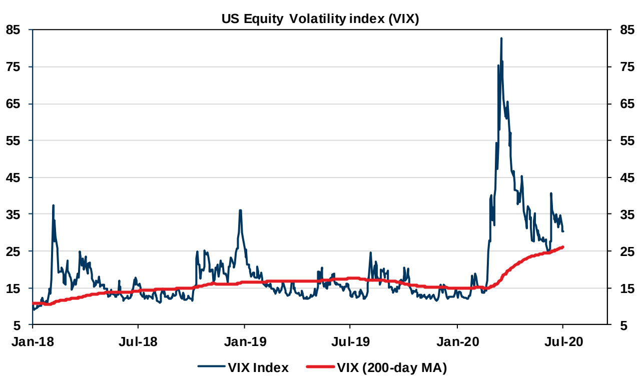
S&P 500 Total Return Index (since 1973*)

5 Best Quarters	Performance	Following Quarter	Following Year	Following 3 Years (Annualized)	Following 5 Years (Annualized)
Q1 1975	23.9%	14.4%	25.7%	5.4%	6.9%
Q4 1998	21.3%	5.0%	21.0%	-1.0%	-0.6%
Q1 1987	21.2%	4.8%	-9.5%	8.4%	10.1%
Q4 1982	19.9%	9.0%	20.9%	19.3%	15.9%
Q4 1985	18.4%	15.2%	18.2%	12.7%	12.8%
Q2 1997	17.5%	7.5%	30.2%	19.7%	3.7%
Q2 2009	15.9%	15.6%	14.4%	16.4%	18.8%
Q3 2009	15.6%	6.0%	10.2%	13.2%	15.7%
Q2 2003	15.4%	2.6%	19.1%	11.2%	7.6%
Q1 1986	15.2%	5.9%	24.4%	10.0%	12.7%
Q2 2020	20.5%	?	?	?	?
Average	18.4%	8.6%	17.5%	11.5%	10.4%
Positive / Total	-	10/10	9/10	9/10	9/10

CIO Office (data via Refinitiv). *Official S&P data since 1988, Datastream reconstructed total return index before.

Nevertheless, markets continued to exhibit a high degree of nervousness, as illustrated by the marked rebound in the S&P 500 volatility index (VIX) mid-month, which refused to settle below its 200-day moving average (Chart 2).

2 ... despite a high level of volatility...

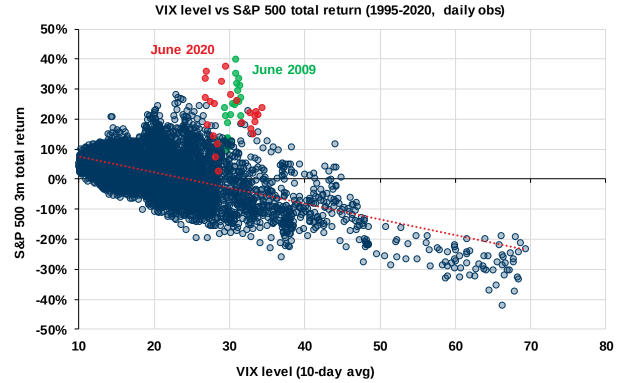


CIO Office (data via Refinitiv).

Looking back in history, we see that it is extremely unusual to observe strong stock market gains in parallel with such an elevated level of volatility. However, one period similar to what we've just experienced stands out: the initial bounce out of the Great Financial Crisis (GFC) (Chart 3). This begs the question: are we in the early days of a new business cycle? And, if so, how does the current situation – referred to as the Great Lockdown - compare to 2009 and what lessons can we learn?

The key to answering this question is whether the recession – which begins when the economy reaches a peak of economic activity and ends when the economy reaches its trough[2] – is over. Judging by the most recent data, it does appear that it

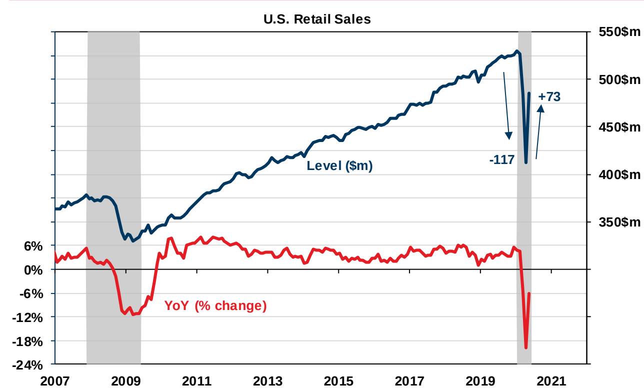
3 ... a combination reminiscent of the 2009 rebound



CIO Office (data via Refinitiv).

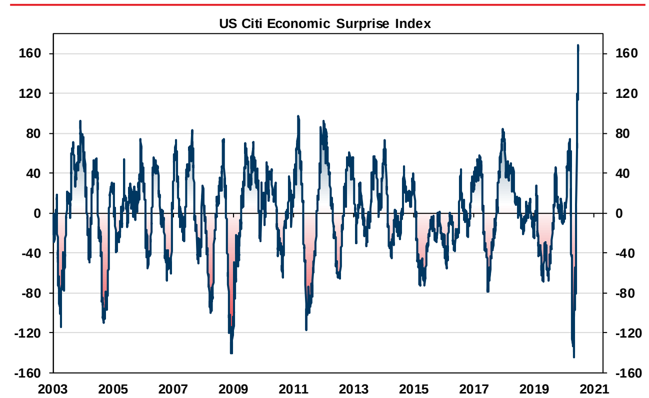
is. For instance, U.S. retail sales have already recovered 62% of their decline (Chart 4). Meanwhile, a consensus expectation of 8 million job losses for May turned out to be wildly inaccurate, with the country actually adding 2.5 million new jobs over the period. As a result, the U.S. Economic Surprise Index currently stands at an all-time high (Chart 5).

4 Retail sales have rebounded sharply...



CIO Office (data via Refinitiv).

5 ... as a majority of recent economic figures



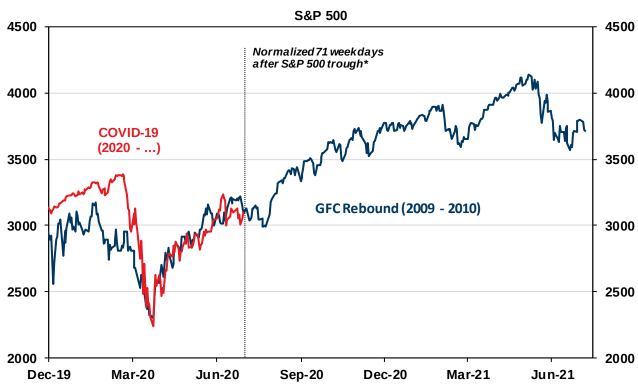
CIO Office (data via Refinitiv).

[2] National Bureau of Economic Research (NBER): Determination of the February 2020 Peak in US Economic Activity.

Evidently, the current context is unique in that the ongoing economic recovery will remain very fragile and uncertain until a durable solution against COVID-19 (clinical treatment and/or vaccine) becomes available. However, if we set this important risk factor aside for a moment, three interesting findings emerge from a comparative analysis with 2009.

First, while the drop in the first quarter of the year has little in common with the financial crisis (the GFC took 18 months for a maximum correction of 57% vs. 2 months and 34% for COVID-19), the trajectory and amplitude of the initial rebound is actually highly similar to what we saw in 2009. Thus, if history repeats itself, we should expect the upward trend in equity markets to carry on in the coming year, although the rally may be due for a break over the summer months (Chart 6).

6 Equity markets should remain on an uptrend...



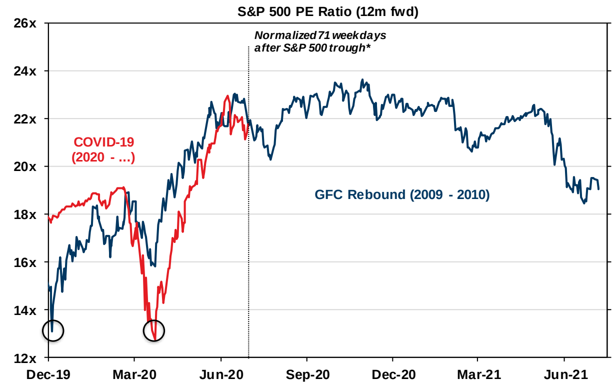
CIO Office (data via Refinitiv). *Normalized to the current S&P 500 level (3100) 71 business days after the S&P 500 low (June 30, 2020, June 16, 2009).

Second, it is normal for a post-crisis rebound to occur almost entirely via an increase in valuations. If we normalize at current levels, we see that the price-earnings (PE) ratio of the S&P 500 had risen by the equivalent of 6 points in the first 3 months of the 2009 recovery, and by 8 points from its absolute bottom.[3] Today, this multiple has also increased by 8 points since the trough of March 23 (Chart 7).

In other words, the valuation increase observed in recent months doesn't appear to be outside historical norms, assuming that we are, indeed, early in a new cycle. Granted, when comparing the level of the PE in June 2009 (~15x) to July 2020 (~22x), one could certainly conclude that valuations are much more frothy nowadays. However, when we adjust this same measure for interest rates and inflation (i.e. the equity risk premium), we actually find that we are roughly at the same valuation level as 11 years earlier (Chart 8). In our view, the main takeaway here is that, while the rise in valuations does not seem excessive given the circumstances, we have probably seen their peak. It is now up to corporate earnings to take over as the main contributor to equity returns in the coming months.

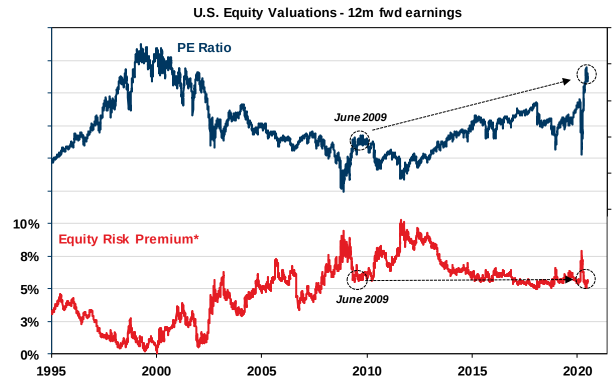
This brings us to the third finding of our comparative analysis with the GFC, which relates to the strength of the recovery in earnings. This is one of the most debated topics right now and, while the latest data bodes well, the prevailing uncertainty

7 ... not via higher valuations...



CIO Office (data via Refinitiv). *Normalized to the current P/E ratio level (21.8x) 71 business days after the bottom of the S&P 500 (June 30, 2020, June 16, 2009).

8 ... although current levels are not exuberant...



CIO Office (data via Refinitiv). *Spread between the S&P 500 foward ernings yield (1/PE) and U.S. 10-year real yields (U.S. 10-year treasury yields deflated with 10-year CPI swap rates, and actual CPI before June 2007).

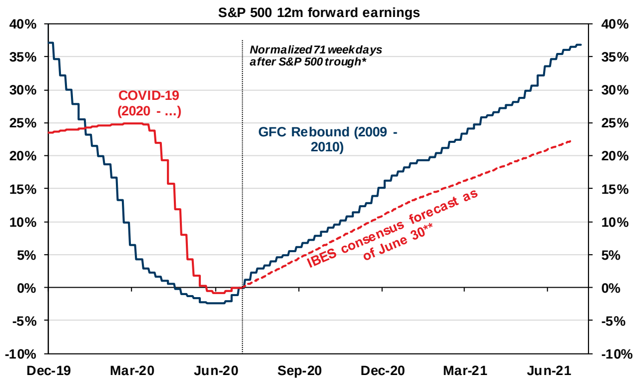
offers little visibility beyond the post-confinement rebound in economic activity. Nevertheless, the trend in 12-month forward earnings will inevitably be upward as the year advances. The question is: will the current consensus prove overly optimistic or overly pessimistic? The upcoming earnings season should shed some light on this matter. But, if we look at the example of 2009-10, it seems that there is still potential for upward revisions (Chart 9, next page).

Now, let's not delude ourselves. While looking back in history is always a good starting point to formulate an outlook, the list of fundamental differences between 2009 and 2020 is long. At the top of it is a pandemic that clearly has not yet had its last say, as data from the United States and elsewhere in the world shows (Chart 10, next page).

Still, even as the number of cases reaccelerate in certain parts of the U.S., it is unlikely that this will lead to a renewal of total

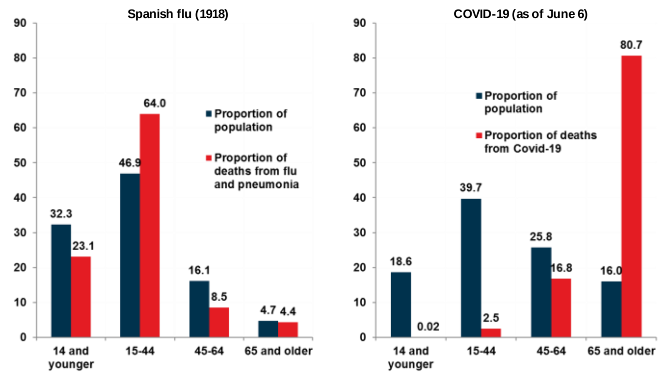
[3] Although the bottom of the S&P 500 during the financial crisis was observed on March 9, 2009, the bottom of the price-earnings ratio was reached 16 weeks earlier, on November 20, 2008.

9 ... but via a recovery in corporate earnings



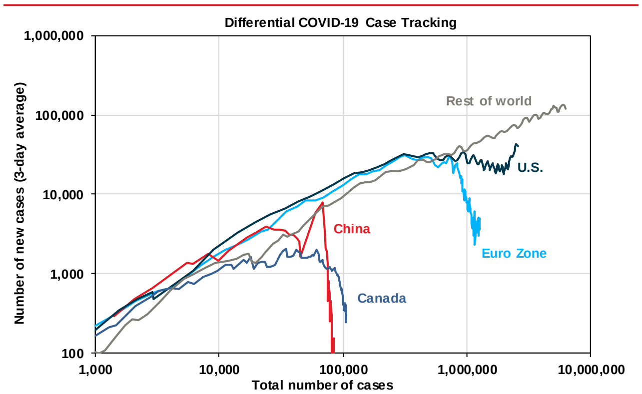
CIO Office (data via Refinitiv). *Normalized to 0% 71 business days after the S&P 500 low (June 30, 2020, June 16, 2009). **Represents the expected earnings trajectory over the next twelve months as we move away from 2020 and into 2021 and 2022.

11 ... but a second total lockdown is unlikely



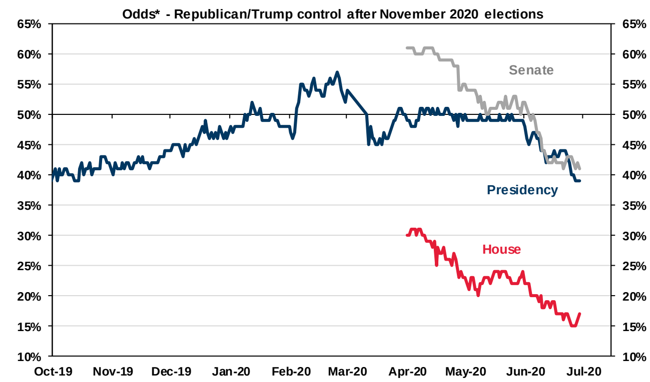
NBF Economics and Strategy (data from CDC, Census Bureau)

10 The pandemic clearly has not yet had its last say...



CIO Office (data via Johns Hopkins University).

12 Things aren't looking great for Republicans



CIO Office (data via *Predictit).

lockdowns, notably because the population most at risk is not part of the labour force unlike during the Spanish flu of 1918[4] (Chart 11). Moreover, some advances in research look promising[5] even though a quick and enduring victory is far from assured.

Another fundamental difference with 2009 is that a U.S. Presidential election is due in just 4 months. Anything can happen when it comes to U.S. politics, especially with President Trump at the helm. However, we must underline that the Democratic candidate seems to be taking advantage of the current backdrop (Chart 12). His election would certainly have the advantage of bringing a dose of stability to international relations and policy-making, but his position on the fiscal front remains a major question mark for markets.

But, in the end, the most important difference between 2009 and 2020 is perhaps the magnitude of actions taken by central banks and fiscal authorities. There are several schools of thought in this area, but one of the generally accepted lessons from the GFC is that in times of crisis, monetary and fiscal measures must be significant and quickly implemented to avoid inflicting permanent damage to the economy. The near-perfect coordination between central banks and governments that we are experiencing is a prime example of this learning. It will certainly create new challenges and lessons to be learned, but the fact remains that it's a major tailwind for the ongoing economic recovery and, consequently, risk assets.

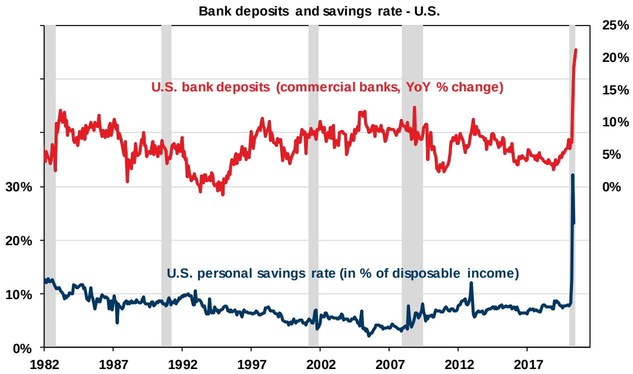
Besides, a look at the growth in bank deposits and the savings rate shows the extent of the liquidity generated in recent months (Chart 13, next page). A fraction of it should migrate toward investments and consumer spending as economies reopen, although it can be assumed that the savings rate will remain higher than in the past.

We should also highlight the positioning (and sentiment) of many investors, which continues to reflect significant pessimism. This is understandable given all the uncertainty prevailing, but the fact remains that such figures are historically good contrarian indicators (i.e. the more pessimism, the more likely it is that the uptrend will continue, Chart 14, next page).

[4] For more details on this matter, see the latest Special Report from our colleagues at NBF Economics and Strategy: Is a second lockdown inevitable?

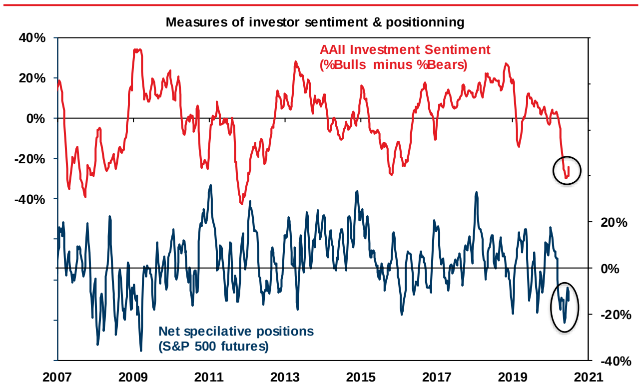
[5] The WHO reports 141 vaccines in evaluation, 16 of which are undergoing clinical evaluation and one (University of Oxford / AstraZeneca) potentially available as early as September. Researchers have also concluded that a low dose of dexamethasone cut the risk of death by a third for patients on ventilators, and by a fifth for those on oxygen.

13 **Liquidity abounds…**



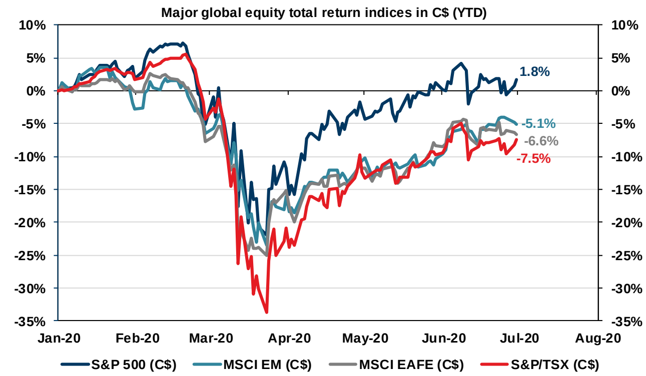
CIO Office (data via Refinitiv).

14 … as does investor pessimism



CIO Office (data via Refinitiv).

15 **S&P 500 still on top… but the gap is narrowing…**



CIO Office (data via Refinitiv).

16 **…with Emerging Markets (i.e. Asia) rebounding sharply**

Emerging Market equities	Weight	Performance (price, US$) Last week	MTD	YTD	1-YR
MSCI EM		-1.9%	7.0%	-10.7%	-5.7%
China	41%	-2.0%	8.4%	2.5%	11.2%
Taiwan	13%	0.2%	8.6%	-2.5%	17.8%
Korea	12%	-0.2%	7.8%	-7.7%	-1.4%
India	8%	-1.8%	6.7%	-17.5%	-18.2%
Brazil	5%	-6.7%	7.3%	-39.5%	-35.3%
South Africa	4%	-3.1%	10.3%	-25.2%	-26.9%
Russia	3%	-6.0%	-2.3%	-25.3%	-17.7%
Qatar	2%	-4.0%	0.0%	-14.8%	-13.1%
Mexico	2%	-4.7%	-0.2%	-28.8%	-26.8%
Indonesia	2%	-0.5%	6.0%	-26.8%	-26.0%

CIO Office (data via Refinitiv). *Only the top 10 countries (by weight) are displayed. As of June 30, 2020.

Overall, we now believe this backdrop justifies a modest pro-risk stance. Accordingly, we've taken a first step in favour of equity markets by deploying our excess cash position early in June. Until recently, we had stuck to a more cautious tactical asset allocation given the downside risks in the near-term. These have obviously not disappeared, and the context should consequently remain highly volatile. However, most recent economic figures confirmed the recovery is well under way which therefore brings the balance of risks back in favour of equity markets.

Equities: The USD Holds the Key

Halfway through 2020, it is still the U.S. market that stands atop the podium. However, the gap between the first and second position has narrowed recently, as emerging markets (EM) managed to deliver a strong gain of 5.8% in C$ (7.4% in USD) in June alone (Chart 15).

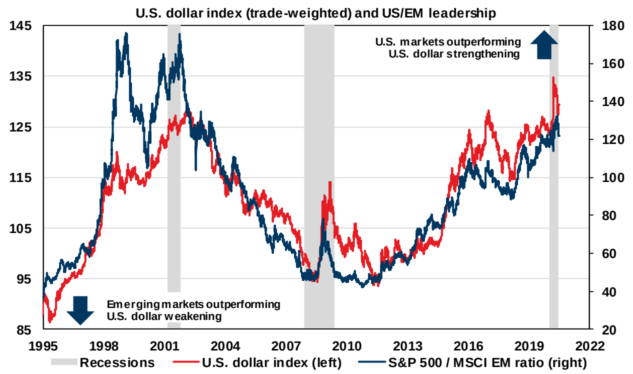
Such a performance may come as a surprise in the current context, especially for anyone who has taken a recent look at economic and coronavirus data out of Latin America. Let us recall, however, that the direction of the MSCI flagship Emerging Markets Index is largely dependent on what happens in Asia (China alone accounts for 40% of the index, Chart 16).

EM outperformance in June remains marginal compared to a decade of sub-par returns relative to developed (read here U.S.) markets, but the recent greenback turnaround is a positive signal for the region. As we mentioned back in April, should the U.S. dollar weaken further effectively easing global financial conditions, reducing borrowing costs for many EM corporations, and influencing capital to flow in faster-growing economies, this could trigger a period of sustained leadership for emerging markets as has historically been the case under such conditions (Chart 17, next page). So, is this what's lying ahead?

If we go back to our comparative analysis between 2009 and 2020 and apply it to the U.S. dollar, we again see some similarities which do point to a continuation of the downtrend in the second half of the year (Chart 18, next page). Not surprisingly, this same analysis suggests that emerging markets may indeed outperform in the coming quarters, although the race should remain tight over the summer months. That is, if history repeats itself, of course (Chart 19, next page).

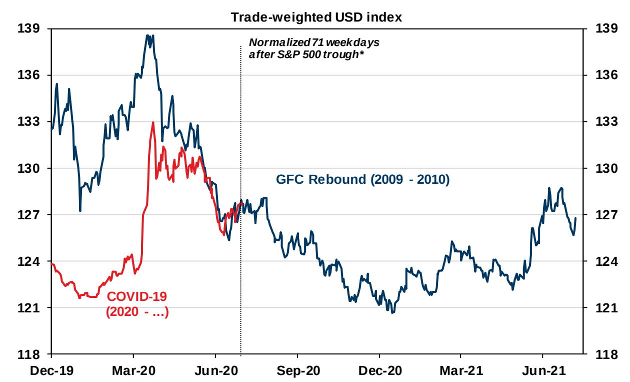
Our GRT model – whose job is to convert the relative trends between the four main equity regions into a recommended allocation – has also shifted slightly in favour of emerging markets recently. It should be emphasized that this move is

17 The dollar holds the key for EM **leadership…**



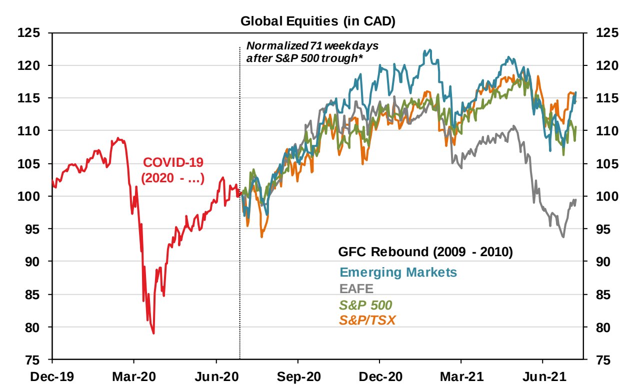
CIO Office (data via Refinitiv).

18 **… and the path of least resistance is down…**



CIO Office (data via Refinitiv). *Normalized to the current level of the $US index (127.6) 71 business days after the bottom of the S&P 500 (June 30, 2020, June 16, 2009).

19 **… which suggests that EM may indeed outperform**

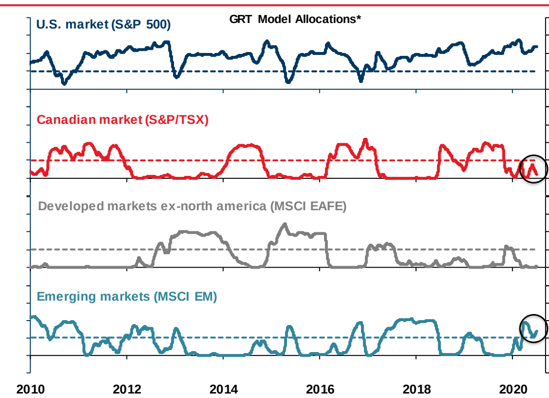


CIO Office (data via Refinitiv). *Normalized to 100 71 weekdays after market trough (June 30, 2020 and June 16, 2009).

mainly to the detriment of Canada, whereas the signal for other developed markets (U.S. and EAFE) has remained relatively stable since the beginning of the year (Chart 20).

For now, we are maintaining our asset mix which overweights the U.S. relative to the EAFE region (in line with the GRT) but remains neutral in emerging markets and Canadian equities. That said, the next few weeks should allow for a better diagnosis of the strength of the economic recovery in the context of a still-very-active pandemic. Should the turn of events justify a more pro-cyclical stance and a second increase in our equity allocation, it will most likely be accompanied by an overweight in emerging markets.

20 Close monitoring of trends between regions



CIO Office (data via Refinitiv). *vs equal weight benchmark.

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General

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