NATIONAL BANK INVESTMENTS

ASSET ALLOCATION STRATEGY | May 2020

Writing the Third Chapter of COVID-19

Highlights

- After plunging into bear market territory in record time in March, equities have just recouped over half of their losses in April – another record. In other words, in the space of just over two months the stock market has experienced what usually occurs over more than a year. First, there was a "shock" phase (the first chapter), where the accumulation of bad news dragged equities into a bear market. Then, a "policy response" period (the second chapter) followed where the actions of central banks and governments point to an economic recovery and lead equities to bounce from oversold levels.
- But no matter how different this time is, markets will still have to go through a period where upbeat economic expectations are confronted with reality (the third chapter). And, that's what we believe is ahead of us over the next few months. We must also not lose sight of the virus, which could cause renewed turbulence should a second wave emerge. Overall, there are grounds for optimism, but the threat cannot be ruled out.
- So, what to expect from this point on? In the near term, upside potential for equity markets appears to be more limited. For instance, the rebound in stock prices together with downward earnings revisions have pushed the S&P 500's price-to-earnings ratio to a new high not seen in almost 20 years. While much of this multiple expansion can be explained by the plunge in interest rates orchestrated by central banks, we suspect that further earnings weakness and a slow path toward "normal" economic activity will confine markets to be range-bound in the coming weeks, or even lead to giving back some of their recent gains. We are therefore maintaining our tactical asset allocation as unchanged for now.
- Large-scale asset purchase programs by central banks seemed to revive many investors' concerns about their potential to create a rapid rise in inflation. In the short and medium term, we must emphasize that the economic downturn is likely to exert strong downward pressure on prices, compounded by the sharp drop in energy prices. Nevertheless, TIPS are likely to fare better than traditional government bonds as depressed inflation expectations ultimately recover.
- Commodities have always been considered the black sheep of financial markets. But in April this claim was taken to another level, as crude oil prices dropped down to negative $37. Although we won't risk predicting another episode of negative prices, intense selling pressure for the June contract is a possibility as it nears expiry. A scenario where prices are higher and sustainable should only be considered once the market is rebalanced, a painful process that is sure to take several months.
- Within equities, U.S. and growth stocks continued to outperform, but small-cap stocks sudden comeback against their larger peers didn't go unnoticed. Periods of sharp small-cap rallies are to be expected but are likely to be short-lived, given that large caps are better equipped to deal with the substantial challenges posed by the current economic backdrop.

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

- It was green across the board for fixed-income products in April, as central bank interventions at home and abroad helped assuage investors' fears across the credit spectrum.
- As a result, the FTSE Canada Overall Universe Index experienced its best monthly performance since 2015 (and second best since 1998!).
- Additional liquidity south of the border – courtesy of the Federal Reserve – was especially helpful in reining in Investment-Grade bond spreads with this asset class outperforming its riskier High-Yield counterpart.

Canadian Equities

- The S&P/TSX's abysmal March performance was followed by an equally impressive rebound in April (up 10.8%).
- A slowing number of new COVID-19 cases, increased testing capacity, awesome amounts of fiscal and monetary stimulus, and indications that Federal and Provincial governments might soon begin to ease lockdowns provided fuel for the equity rally.
- Impressive performances from the Materials, IT, and Consumer Discretionary sectors helped lead the rally.

U.S. Equities

- Not to be outdone by its cousin to the north, the S&P 500 also climbed higher (up 12.8%), as similar monetary and fiscal measures to Canada helped lift investor sentiment, even as the total number of initial jobless claims for the period shattered previous records.
- The index's strongest monthly performance since January 1987 could not be called broad-based however, as the range of year-to-date returns across sectors remains quite wide.
- As a result, the index now finds itself 0.9% <u>above</u> its level from 12 months ago.

Commodities

- Last month, the COVID-19-induced negative demand shock contributed to pushed WTI prices to fall into negative territory for the first time in history.
- Rapidly dwindling storage capacity in Cushing, Oklahoma, played an important role in the event, as many holders of oil futures were in the awkward position of having to pay buyers to take the oil of their hands.
- Prices finally settled near $18.8/bbl at month's end.
- Meanwhile, gold maintained its momentum throughout April, spurred on by the prospect of lower real rates, with the bullion trading over $1700/oz. by the end of the period.

Foreign Exchange

- Following wild swings in March, the U.S. Dollar Index remained relatively range-bound throughout the month of April.
- Surprisingly stable in the face of record high oil price volatility, the Loonie closed out last month having appreciated slightly and now trading near $0.72 US.

Table 2 Market Total Returns

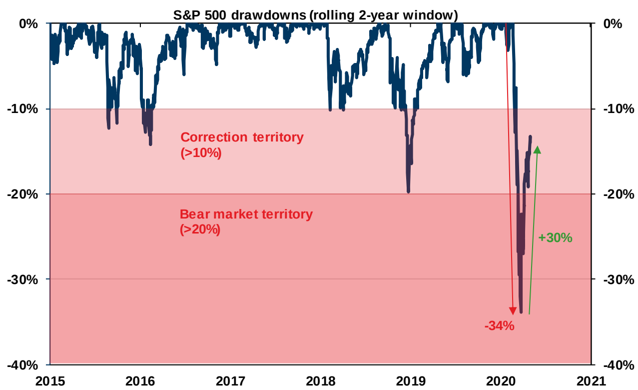
Asset Classes	April	YTD	12 months
Cash (3-month T-bills)	0.0%	0.7%	1.8%
Bonds (FTSE CA Ovr. Univ.)	**3.8%**	**5.4%**	**8.5%**
FTSE CA Short term	1.3%	3.2%	4.3%
FTSE CA Mid term	3.3%	6.7%	8.6%
FTSE CA Long term	7.1%	7.2%	13.9%
FTSE CA Government	3.4%	6.7%	9.6%
Federal	1.5%	6.8%	8.3%
Provincial	5.2%	6.6%	10.8%
Municipal	4.6%	5.8%	9.9%
FTSE CA Corporate	4.8%	2.2%	5.8%
AA+	2.7%	3.1%	4.8%
BBB	5.5%	1.1%	5.0%
BoAML Inv. Grade ($US)	5.3%	1.0%	9.3%
BoAML High-Yield (USD)	3.8%	-9.8%	-5.3%
Preferred Shares	12.6%	-13.1%	-11.2%
Canadian Equities (S&P/TSX)	**10.8%**	**-12.4%**	**-7.9%**
Energy	12.8%	-29.1%	-27.9%
Industrials	9.0%	-7.4%	-3.2%
Financials	1.7%	-19.7%	-16.7%
Materials	33.0%	8.0%	26.4%
Utilities	3.9%	-1.6%	15.9%
Cons. Disc	20.3%	-19.2%	-20.8%
Cons. Staples	7.2%	-2.8%	-0.2%
Healthcare	7.8%	-32.2%	-60.3%
IT	29.3%	24.5%	53.1%
Comm. Svc.	-0.3%	-8.4%	-5.1%
REITs	8.0%	-22.7%	-17.3%
S&P/TSX Small Cap	25.1%	-22.6%	-18.8%
US Equities (S&P500 USD)	**12.8%**	**-9.3%**	**0.9%**
Energy	29.8%	-35.7%	-38.3%
Industrials	8.7%	-20.7%	-15.9%
Financials	9.6%	-25.4%	-16.7%
Materials	15.3%	-14.8%	-7.2%
Utilities	3.2%	-10.7%	0.8%
Cons. Disc	20.5%	-2.7%	1.8%
Cons. Staples	6.9%	-6.8%	3.6%
Healthcare	12.6%	-1.6%	14.5%
IT	13.8%	0.2%	18.1%
Comm. Svc.	13.8%	-5.5%	3.3%
REITs	9.5%	-11.6%	-2.5%
Russell 2000 (USD)	13.7%	-21.4%	-17.6%
World Eq. (MSCI ACWI)	**10.8%**	**-12.8%**	**-4.4%**
MSCI EAFE (USD)	6.5%	-17.7%	-10.9%
MSCI EM (USD)	9.2%	-16.6%	-11.7%
Commodities (CRB index)	**-4.6%**	**-12.0%**	**-16.3%**
WTI Oil (US$/barrel)	-8.0%	-69.2%	-70.5%
Gold (US$/ounce)	5.8%	12.1%	32.9%
Copper (US$/tonne)	4.5%	-16.1%	-19.7%
Forex (DXY - US Dollar index)	**0.0%**	**2.7%**	**1.6%**
USD per EUR	-0.2%	-2.4%	-2.3%
CAD per USD	-0.8%	7.4%	4.1%

CIO Office (data via Refinitiv) 4/30/2020

Writing the Third Chapter of COVID-19

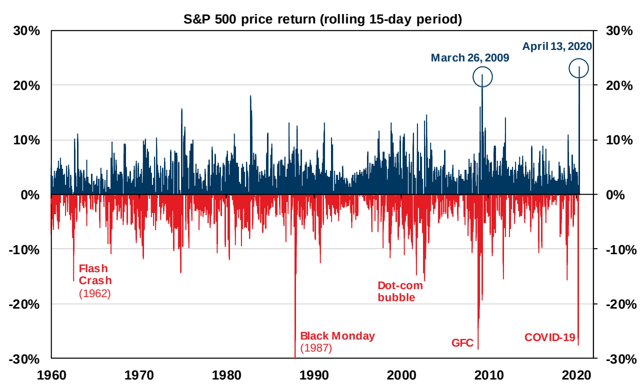
After plunging into bear market territory in record time in March, as COVID-19 evolved from a predominantly Chinese epidemic to a global pandemic, the following weeks saw U.S. equities recoup a little over half of their losses (Chart 1), a spectacular rally that is reminiscent of the rebound that marked the end of the financial crisis in March 2009 (Chart 2).

1 After a record drop, a spectacular rebound...



CIO Office (data via Refinitiv).

2 ... reminiscent of March 2009...

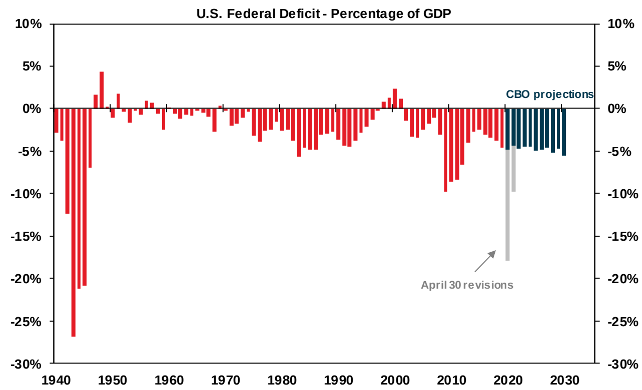


CIO Office (data via Refinitiv).

The key factor behind this stock market recovery is evidently the massive and coordinated response from government bodies: wartime-like fiscal deficits (Chart 3); the fastest monetary expansion in history (Chart 4); and, most importantly, strict containment measures that have proven to be effective in slowing the spread of the virus thus far (Chart 5). Accordingly, our market sentiment indicator exited extreme pessimism levels on April 9 and is now near the neutral point (Chart 6, next page).

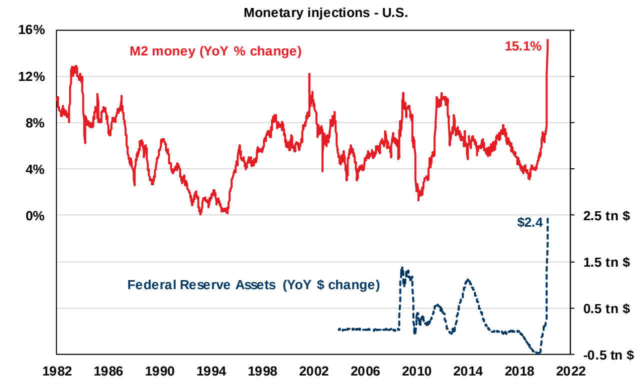
In other words, in the space of just over two months the stock market has experienced what usually occurs over more than a year. First, there was a "shock" phase (the first chapter), where the accumulation of bad news (sometimes purely event-driven, sometimes cyclical or structural) dragged equities into a bear market. Then, a "policy response" period (the second chapter) followed, where the actions of central banks and governments point to an economic recovery and lead equities to bounce from oversold levels (Chart 7, next page).

3 ... thanks to war-time like fiscal deficits...



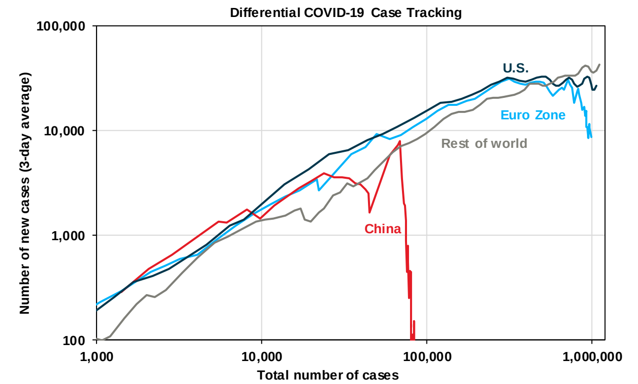
CIO Office (data via Fred, Congressional Budget Office).

4 ... the fastest monetary expansion in history...



CIO Office (data via Refinitiv).

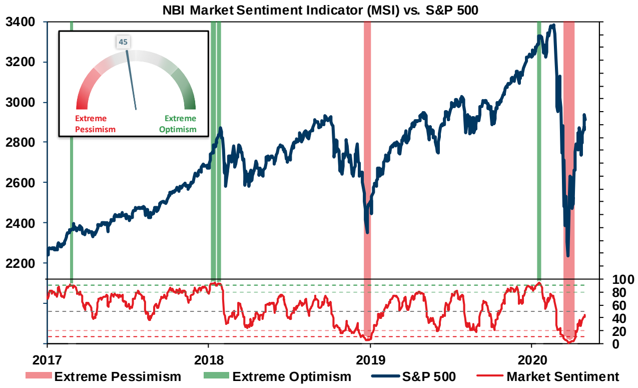
5 ... and a deceleration in new COVID-19 cases



CIO Office (data via Refinitiv).

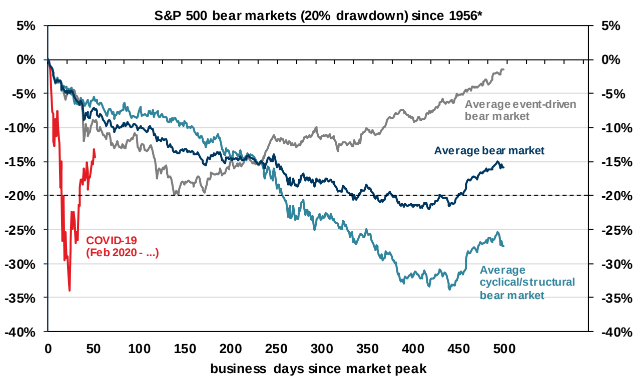
This disconnection from historical precedents is an obvious consequence of the highly unusual nature of the current (self-imposed) economic downturn. But, no matter how different this time is, markets will still have to go through a period where upbeat economic expectations are confronted with reality (the third chapter). And, that's what we believe is ahead of us over the next few months.

6 Market sentiment is picking up



CIO Office (data via Refinitiv).

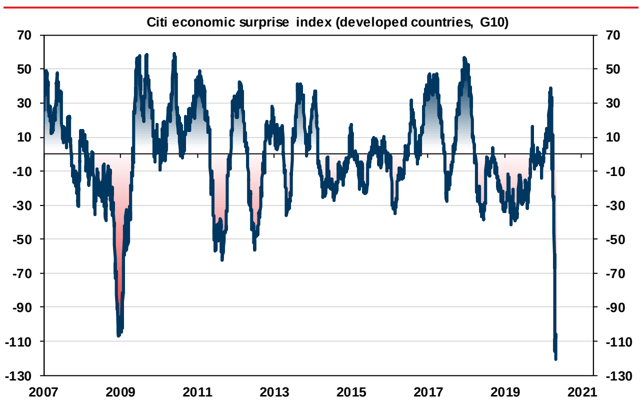
7 A bear market like no other



CIO Office (data via Refinitiv). *Event-driven = 1959, 1961, 1966, 1987. Cyclical/structural = 1968, 1980, 2000, 2007

As such, one indicator that we'll keep on the radar screen is the Global Economic Surprise Index, whose specific function measures the comparison between economic data versus consensus. For now, the market has seemingly ignored its precipitous plunge, but the trend will eventually need to reverse for equities to keep pace – as it did back in 2009 (Chart 8).

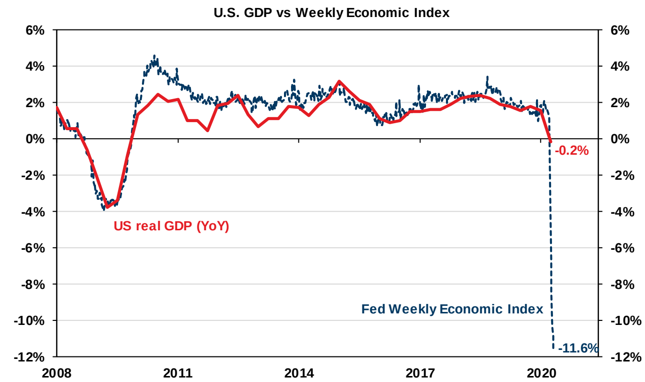
8 Will reality match expectations?



CIO Office (data via Refinitiv).

Besides, we should not expect an imminent return to healthy economic figures. For instance, the release of a 4.8% annualized contraction for the U.S. GDP in Q1 (-0.2% YoY) only portends what will likely be a much larger drop in the current quarter, as indicated by the Federal Reserve's new Weekly Economic Index (Chart 9).

9 Don't expect an imminent return to better growth

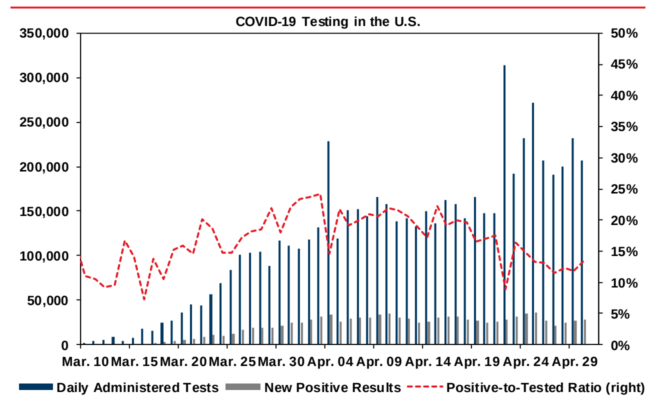


CIO Office (data via Refinitiv).

We must also not lose sight of the virus, which could cause renewed turbulence should a second wave emerge. Overall, there are grounds for optimism considering (1) China has demonstrated that it is possible to reopen an economy while maintaining COVID-19 cases at a minimum, (2) the vast majority of the world's population must now be familiar with best practices to limit contagion, and (3) countries are significantly scaling up their testing capacity, notably in the U.S. (Chart 10). Nevertheless, the threat cannot be ruled out, as the Executive Director for the World Health Organization's Health Emergencies Programme, Dr. Michael J. Ryan, highlighted on April 27:

> *"[If] restrictions are eased too early, you may be back in a situation where lockdowns have to be re-imposed, and that again has [...] potentially an even greater impact on livelihoods."*

10 Testing capacity is increasing in the United States

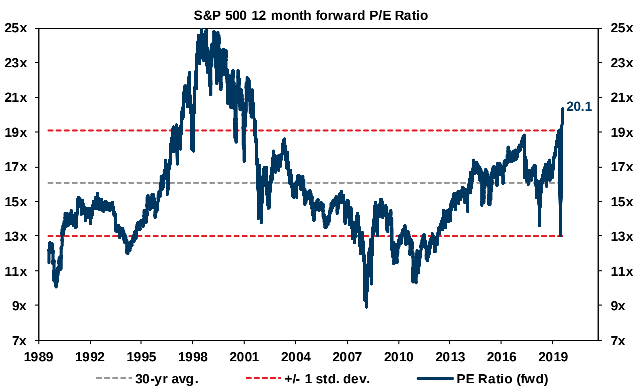


CIO Office (data via Refinitiv).

So, what to expect from markets from this point on? Over a longer-term horizon (> 12 months), we continue to believe the outlook for equities compares favourably to safer bonds. This is what we argued on March 18 when we concluded the current situation represented more of an opportunity than a threat. Since we have moved away from more dire scenarios, this is now all the more true.

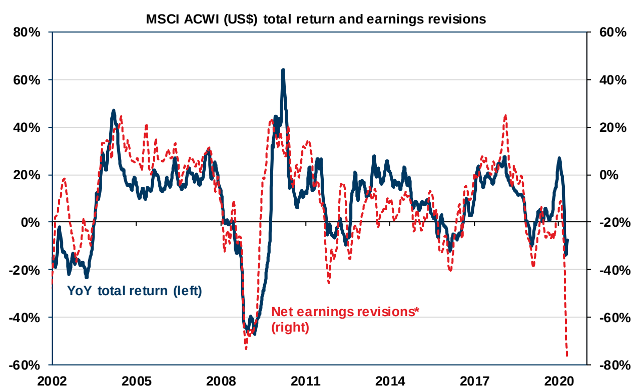
In the near term, however, upside potential for equity markets appears to be more limited. For instance, the rebound in stock prices together with downward earnings revisions have pushed the S&P 500's price-to-earnings ratio to a new high not seen in nearly 20 years (Chart 11). While much of this multiple expansion can be explained by the plunge in interest rates orchestrated by central banks, we suspect that further earnings weakness (Chart 12) and a slow path toward "normal" economic activity will confine markets to be range-bound in the coming weeks, or even lead to giving back some of their recent gains.

11 Near term upside potential is limited...



CIO Office (data via Refinitiv).

12 ... by the weight of downward earnings revisions



CIO Office (data via Refinitiv). *net positive revisions divided by total revisions

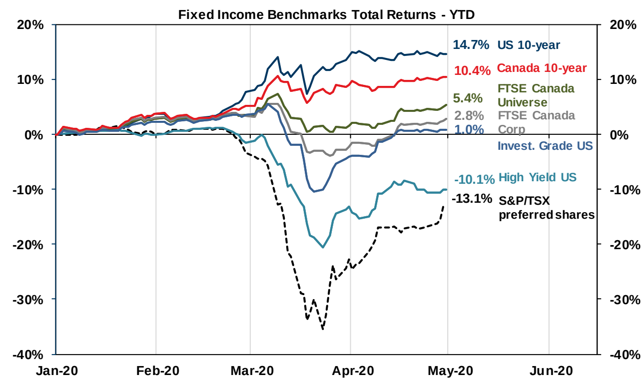
A new episode in the geopolitical saga pitting the United States against China could also deflate stock prices. Sooner rather than later, the current U.S. administration will look to spin this crisis in their favour in the run-up to the November elections. This is likely to involve tougher policies toward the rival country where the virus first appeared.

Under these circumstances, we are maintaining our tactical asset allocation (neutral in equities, underweight in fixed income, and overweight cash) unchanged for now, and we stand ready to make changes as the situation evolves.

Fixed Income: Real Opportunities?

After experiencing a shockwave in March, the massive injection of liquidity by central banks allowed fixed-income assets to improve their performance last month. Deeply oversold preferred shares rebounded most strongly (+12.6% in April), followed by U.S. investment grade credit (+5.2%) and U.S. high yield (+3.5%) (Chart 13).

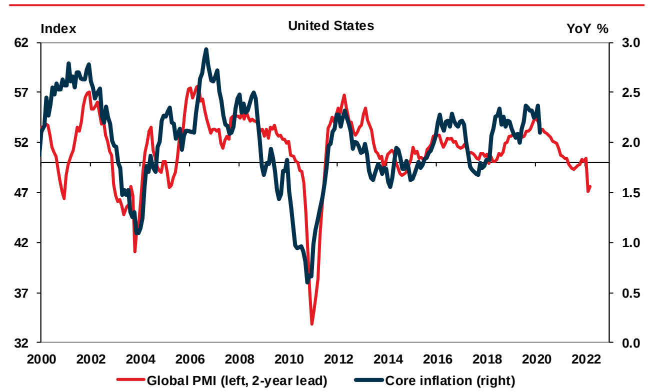
13 Better days for fixed income assets in April



CIO Office (data via Refinitiv).

Large-scale asset purchase programs by central banks seemed to revive many investors' concerns about their potential to create a rapid rise in inflation. In the short and medium term, we must emphasize that the economic downturn is likely to exert strong downward pressure on prices (Chart 14), compounded by the sharp drop in energy prices. Monetary policy seeks only to prevent these forces from pushing the economy into a deflationary spiral.

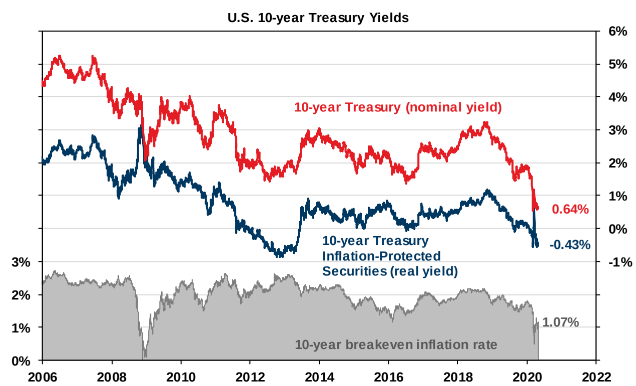
14 **Realized inflation should trend lower in the near future...**



CIO Office (data via Refinitiv).

Looking further ahead, a case can certainly be made for higher inflation, notably because high indebtedness will likely force central banks to remain accommodative well beyond this economic downturn. So, should investors shift their asset allocations toward fixed-come assets that are better shielded against inflation, such as U.S. TIPS (Treasury Inflation-Protected Securities)? Relative to traditional government bonds, yes, TIPS are likely to perform better as inflation expectations recover. Currently, the 10-year breakeven inflation rate is only 1.07%, i.e. TIPS will outperform U.S. Treasury notes if inflation averages more than 1.07% over the next decade. The odds of this happening are good. That said, total return expectations for TIPS remain low over the long term as their real rate is currently negative. Hence, we stress that they are a good substitute for traditional government debt, but less so for riskier securities (Chart 15).

15 ... but TIPS are likely to outperform Treasury notes



CIO Office (data via Refinitiv).

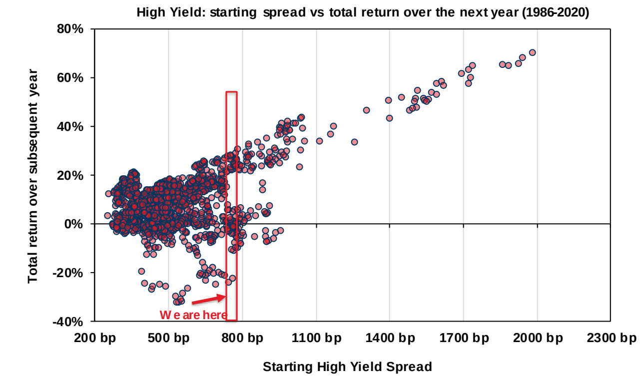
Speaking of riskier securities, in April, high-yield and investment-grade credit spreads both narrowed, although they remain in the upper end of their historical range (Chart 16).

16 Credit spreads have come down from their highs

CIO Office (data via Refinitiv).

For now, we continue to recommend investment grade over high yield, as many lower grade issuers are likely to struggle with payments in the coming months. However, notwithstanding downside risk in the short term, we must recognize that at current valuation levels, high-yield return prospects over a one-year horizon are skewed to the upside (Chart 17).

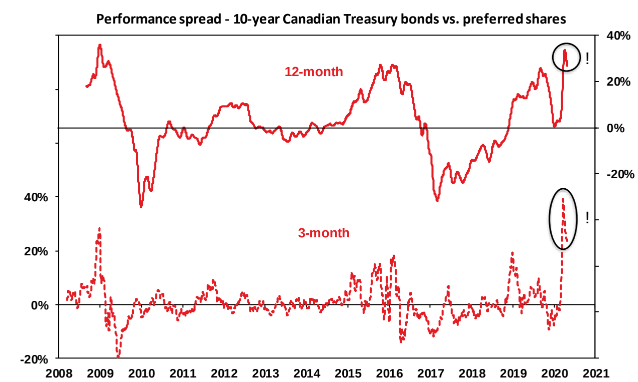
17 High Yield: risky... but skewed to the upside



CIO Office (data via Refinitiv).

Similarly, Canadian preferred shares have reached attractive valuation levels in recent weeks relative to government bonds. Historically, such conditions have preceded turnarounds particularly beneficial to the asset class, and would seem more and more probable should market conditions continue to improve over the next few months (Chart 18).

18 Value opportunity in Canadian preferred shares?



CIO Office (data via Refinitiv).

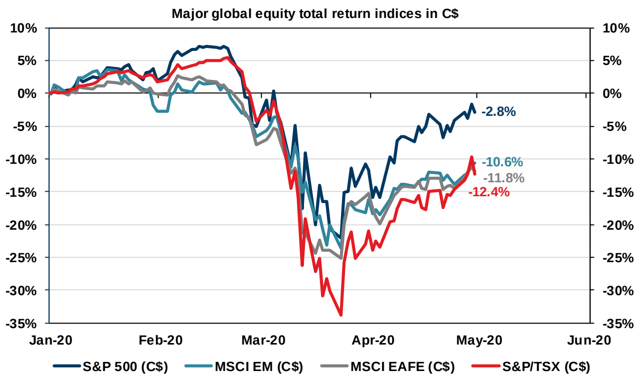
Equities: Sizing Leadership

Global equity markets rebounded at full speed in April, this rally even taking the S&P 500 just shy of positive territory year-to-date when measured in Canadian dollars – who would have thought (Chart 19, next page)?

In terms of leadership, U.S. and growth stocks continued to outperform in the rebound. However, small-cap stocks staged a sharp and sudden comeback against their larger peers late in April (Chart 20, next page). Is this the beginning of a sustained rotation in their favour?

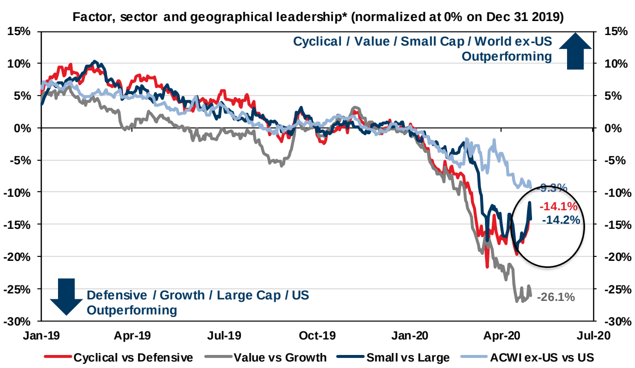
If one stands back to look at the ratio between small and large caps over the last three decades, one can see that some mean reversion was imminent given the extent of large cap outperformance in recent months (Chart 21, next page).

19 S&P 500 nearly positive in 2020 (in C$) !?



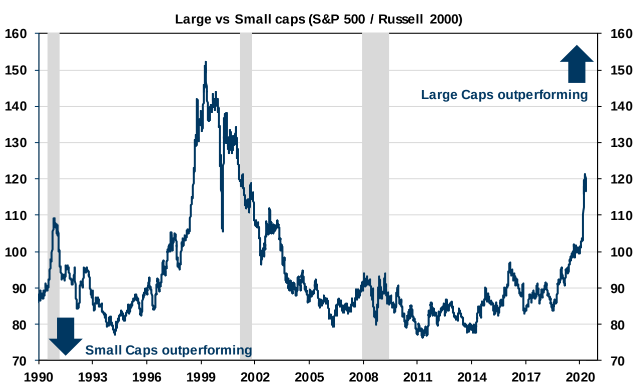
CIO Office (data via Refinitiv).

20 A marked rebound of small caps in late April...



CIO Office (data via Refinitiv).

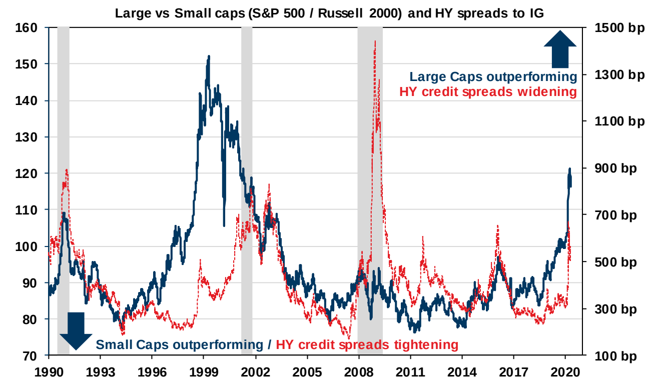
21 ... was not so surprising...



CIO Office (data via Refinitiv).

Now, what would it take for this reversal to carry forward? One of the key characteristics of companies in the U.S. Russell 2000 Index is that their balance sheets tend to be riskier – more leveraged – than their S&P 500 peers, which is why the ratio between the two tends to follow the direction of high-yield vs. investment-grade credit spreads (Chart 22).

22 ... but higher-quality large caps should retain leadership...

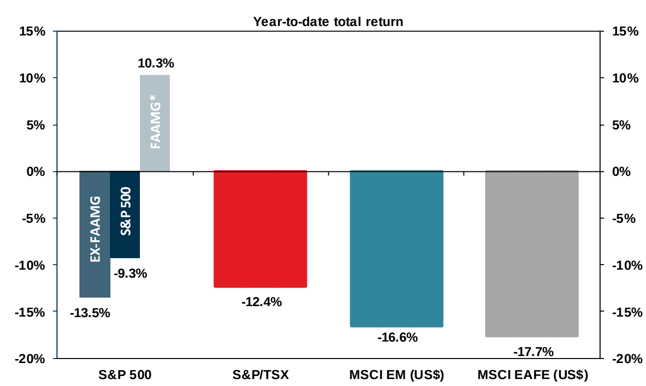


CIO Office (data via Refinitiv).

Thus, although we are likely to see other periods of sharp small-cap rallies when the performance spread reaches extreme levels, those are likely to be short-lived as only a substantial and rapid improvement in economic fundamentals could lead to sustained small-cap leadership. Consequently, we expect the trend to remain favourable for large caps over the coming months as they are better equipped to deal with the substantial challenges posed by the current economic backdrop.

Moreover, good examples of companies arguably better positioned to weather the current crisis are the five largest companies in the S&P 500, the well-known FAAMGs, which together represent about 20% of the index. Their just-published quarterly earnings results have evidenced their financial resilience, and that's an advantage that makes – and should continue to make – all the difference for the U.S. stock market (Chart 23).

23 ... to the benefit of the U.S. stock market

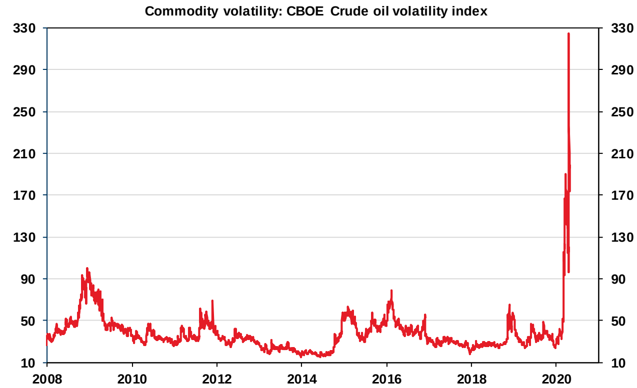


CIO Office (data via Refinitiv). *FAAMG = Facebook, Amazon, Apple, Microsoft, Google (Alphabet)

Commodities: Negative Energy

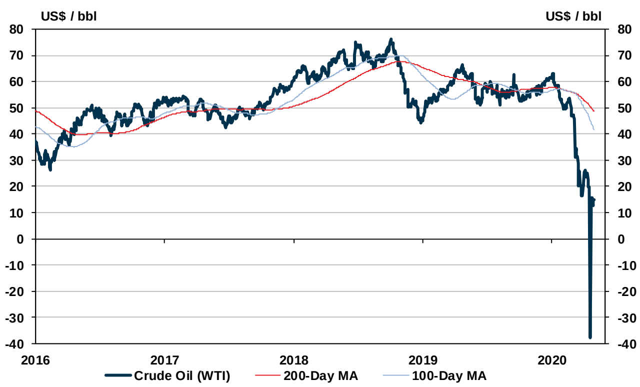
Commodities have always been considered the black sheep of financial markets, as they are prone to extreme bouts of volatility. However, this claim was taken to another level in April (Chart 24, next page), as crude oil prices dropped down to *negative* $37 (Chart 25, next page). How is that even possible?

24 Oil redefined the term "extreme volatility" in April...



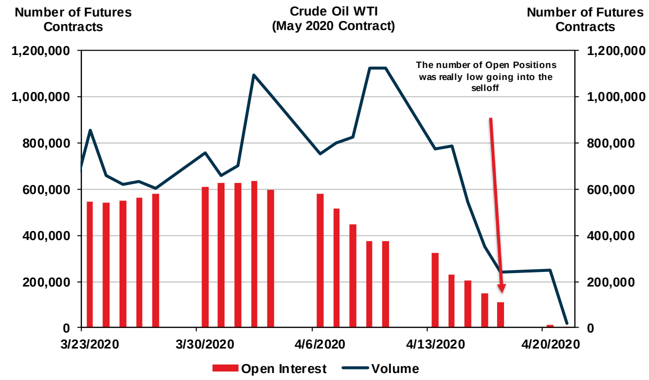
CIO Office (data via Refinitiv).

25 **...as prices per barrel dropped to $37... below zero**



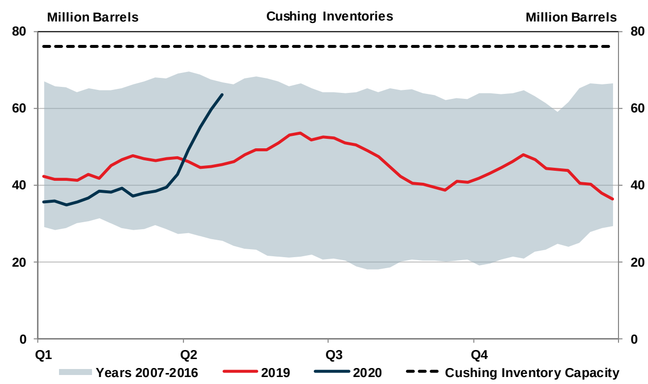
CIO Office (data via Refinitiv).

26 Liquidity dries up as contracts near expiry



CIO Office (data via Refinitiv).

27 Space is running out and the trend is worrying



CIO Office (data via Refinitiv).

The answer lies in a mix of (1) contract specifications, (2) supply and demand fundamentals, and (3) market positioning:

1. Contract Specifications: One major aspect often overlooked when dealing with commodity futures contracts is that these financial instruments are fundamentally tied to their underlying physical market. In other words, when you buy a WTI futures contract, you have the obligation to take physical delivery of crude oil barrels at expiry of said contract in Cushing, Oklahoma. Despite those specifications, only a minimal number of contracts result in physical delivery as most participants close out their futures exposure before the expiry date, and this usually results in much less volume and liquidity in the last days of the contract (Chart 26).
2. Supply and demand picture: The Covid-19-related production surplus generated by a general closing of the economy created a glut which created some operational constraints regarding storage capacity (Chart 27). Transport is another issue, as having available storage is useless if there's no way to bring crude oil to it. Under normal circumstances, the system works well. However, the speed and amplitude of production surpluses created a lot of stress in the system which made it vulnerable to a systemic failure.
3. Market positioning: As the May WTI contract was nearing expiry most of the positions were either closed out or rolled into the June WTI contract. However, some retail investors, notably in China, were still invested in the May one via an ETF even as underlying liquidity was quickly drying up.
4. Tying it all together: Under normal circumstances, a seller close to expiry will find a bid for the right price. But this time, the combination of storage and transport constraints plus near-nonexistent liquidity resulted in negative prices as no one wanted to deal with those barrels. Basically, sellers had to pay to have someone take crude oil off their hands as they had no physical capacity to hold barrels themselves.

In a way, the -$37 bottom reflects more a panic-induced move by financial actors than a clear reflection of market fundamentals. The Covid-19 demand reduction didn't directly cause the negative prices, but rather set about an environment where such an event could be possible. All that was needed was a spark, which in this case came from retail investors who were left holding the hot potato without any oven mitts.

However, we can't ignore the fact that this event shows how unbalanced and under stress energy markets currently are. We expect prices to remain low and extremely volatile on the near-term horizon. Although we won't risk predicting another episode of negative prices, intense selling pressure for the June contract as it nears expiry is a possibility, if operational constraints are present.

A scenario where prices are higher and sustainable should only be considered once the market is rebalanced. On the supply side, this presumes that the energy sector will have undergone a rationalization process via shut-ins, while the demand side recovers as the global economy rebounds – a painful process that is sure to take several months.

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