NATIONAL BANK INVESTMENTS

ASSET ALLOCATION STRATEGY

November 2020

Red or Blue?

Highlights

- Equity markets remained hesitant in October, with a U.S. fiscal stimulus package still pending and several European countries announcing new restrictions to slow the spread of new coronavirus cases. That said, with American voters going to the polls tomorrow, investors will soon have one less reason to waver as we will finally know the colour – Republican Red or Democrat Blue – of the ruling party for the next four years.
- In-depth analysis of state polls suggests a blue sweep is the most likely scenario, with a probability of a Biden victory and the Senate passing to the Democrats with 89% and 76%, respectively. That said, odds observed in the betting markets – arguably a better reflection of what is discounted in financial markets – suggest a much closer race: a 60% chance of victory for Biden and 59% for the Democrats in the Senate.
- Looking beyond the potential for short-term turbulence, it is important to reiterate that we expect the nascent bull market to steam ahead over the medium term, regardless of tomorrow's outcome. This doesn't mean markets are completely agnostic to the election results. One asset that we will be watching closely is the U.S. dollar and its tight relationship with the relative performance between emerging markets and U.S. equities. The other macro variable we will be closely monitoring is yields on U.S. Treasuries, which rose in October despite the risk-off environment, testing their 200-day moving average for the first time in almost two years.
- In any event, election results will only provide a partial answer to the many questions that have left markets hesitant in recent months. More specifically, two other points must be clarified for the stock market recovery to move to the next level: (1) when will a fiscal stimulus package be passed and, most importantly, (2) when will a more permanent solution to the pandemic be introduced?
- With the new Congress being seated only in January, any large-scale stimulus package is unlikely to be voted on before 2021. If Democrats win the Senate, markets should manage to cope with this delay without too much trouble by discounting the imminence of a major fiscal stimulus. The risk is rather one of marked deterioration in economic activity between now and the end of the year combined with a Senate left in the hands of fiscally conservative Republican Senators.
- In the words of Dr. Fauci, "*we will know whether a vaccine is safe and effective by the end of November, beginning of December.*" While it is impossible to know for certain whether news will be positive, recent reports seem somewhat promising, as reflected in the increased likelihood a vaccine will be available by the end of Q1 2021.

Table 1 Global Asset Allocation Views

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Asset Classes		
Cash		
Fixed Income		
Equities		
Alternatives		
Fixed Income		
Government		
Investment Grade		
High Yield		
Duration		
Equities		
Canada		
United States		
EAFE		
Emerging Markets		
Value <---> Growth		
Small <---> Large Cap.		
Low Vol <---> High Beta		
Alternatives & FX		
Inflation Protection		
Gold		
Non-Traditional FI		
Uncorrelated Strategies		
Canadian Dollar		

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, 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 balanced portfolio.

CIO Office

Market Review

Fixed Income

- The U.S. 10-year benchmark yield rose throughout the month of October, while short-term rates remain unchanged.
- It was a relatively quiet month for credit spreads as well, even as the reacceleration in COVID-19 cases and renewed confinement measures across many developed countries cast shadows on the ongoing recovery.

Canadian Equities

- October played host to yet another month of seesawing for Canada's main Equity Index, as investors remained wary of a second (and in some cases, a third) wave of COVID-19 cases.
- The Index closed out the period falling abruptly below its 100-day moving average as it became clear many European countries would once again be forced to enact targeted lockdowns.
- Meanwhile, the latest earnings season provided investors with some positive news, as the blended year-over-year earnings growth figure for the S&P/TSX improved by four percentage points by month's end, with still another 72% of companies yet to report.

U.S. Equities

- In similar fashion to its northern cousin, the S&P 500 evolved with no clear direction over the last three months, circling its pre-COVID peak during that time.
- Even as over 50% of companies have now reported third-quarter earnings with an impressive 85% of these providing positive surprises, the Index still failed to deliver a positive performance ahead of election day.
- Implied volatility – as measured by the VIX Index – spiked, however, in lockstep with the steep rise in COVID-19 cases seen in many parts of the U.S.

Commodities

- Gold prices remained relatively flat in October, unfazed by the risk-off mood.
- The lustrous metal now stands 9% down from its all-time high set back in July.
- Meanwhile, the price of a barrel of WTI oil stumbled late in the month, also succumbing to the prospect of renewed lockdowns across major developed nations leading to a reduction in demand.

Foreign Exchange

- The USD remained relatively unchanged last month.
- Pressures pulling in both directions – the growing economic uncertainty from a steeply rising COVID-19 case count versus the increasing likelihood of a Democrat sweep in the elections that could pose trouble for the Greenback – seemed to balance each other out.

Table 2 Market Total Returns

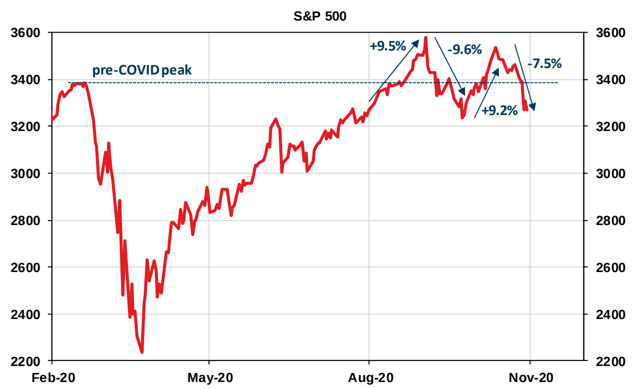
Asset Classes	October	YTD	12 months
Cash (3-month T-bills)	0.0%	0.8%	1.1%
Bonds (FTSE CA Ovr. Univ.)	-0.8%	7.2%	6.5%
FTSE CA Short term	0.0%	4.8%	4.7%
FTSE CA Mid term	-0.5%	8.9%	7.8%
FTSE CA Long term	-1.9%	8.9%	7.6%
FTSE CA Government	-0.8%	7.6%	6.5%
Federal	-0.5%	7.0%	5.9%
Provincial	-1.1%	8.0%	7.0%
Municipal	-0.8%	8.5%	7.6%
FTSE CA Corporate	-0.6%	6.2%	6.3%
AA+	0.0%	5.4%	5.4%
BBB	-0.8%	6.3%	6.6%
BoAML Inv. Grade ($US)	-0.2%	6.4%	7.0%
BoAML High-Yield ($US)	0.5%	0.2%	2.5%
Preferred Shares	-0.4%	-1.5%	2.2%
Canadian Equities (S&P/TSX)	-3.1%	-6.1%	-2.3%
Energy	-4.6%	-38.9%	-31.7%
Industrials	-3.4%	5.6%	10.1%
Financials	-1.7%	-14.3%	-13.9%
Materials	-2.0%	23.3%	29.1%
Utilities	-1.1%	8.0%	11.2%
Cons. Disc	-0.2%	-3.5%	-1.6%
Cons. Staples	-7.5%	2.2%	2.9%
Healthcare	7.4%	-36.4%	-37.3%
IT	-8.7%	53.2%	71.7%
Comm. Svc.	-3.0%	-9.9%	-7.7%
REITs	-0.5%	-17.2%	-17.2%
S&P/TSX Small Cap	-0.7%	-9.3%	-1.8%
US Equities (S&P500 USD)	-2.7%	2.8%	9.7%
Energy	-4.4%	-50.4%	-46.4%
Industrials	-1.4%	-5.4%	-1.2%
Financials	-0.8%	-20.9%	-14.6%
Materials	-0.8%	4.6%	11.3%
Utilities	5.0%	-0.9%	0.6%
Cons. Disc	-2.9%	19.8%	24.7%
Cons. Staples	-2.8%	1.2%	4.9%
Healthcare	-3.7%	1.1%	10.1%
IT	-5.1%	22.1%	34.5%
Comm. Svc.	0.8%	9.5%	15.8%
REITs	-3.3%	-9.9%	-10.3%
Russell 2000 (USD)	2.0%	-7.8%	-1.5%
World Eq. (MSCI ACWI)	-2.4%	-0.7%	5.4%
MSCI EAFE (USD)	-4.0%	-10.4%	-6.5%
MSCI EM (USD)	2.1%	1.1%	8.6%
Commodities (CRB index)	-2.5%	-21.8%	-17.7%
WTI Oil (US$/barrel)	-10.2%	-41.1%	-33.3%
Gold (US$/ounce)	-1.0%	23.7%	24.5%
Copper (US$/tonne)	0.6%	9.1%	16.3%
Forex (DXY - US Dollar index)	0.2%	-2.4%	-3.4%
USD per EUR	-0.7%	3.8%	4.4%
CAD per USD	0.0%	2.5%	1.2%

CIO Office (data via Refinitiv) 2020-10-30

Red or Blue?

Equity markets remained hesitant in October, with a U.S. fiscal stimulus package still pending and several European countries announcing new restrictions to slow the spread of new coronavirus cases. In fact, stocks have been evolving with no clear direction for three months now, with the S&P 500 moving up and down nearly 10% around its pre-COVID level since August for a net performance of 0.0% (+0.4% total return) over the period (Chart 1).

1 Markets have been hesitant for three months

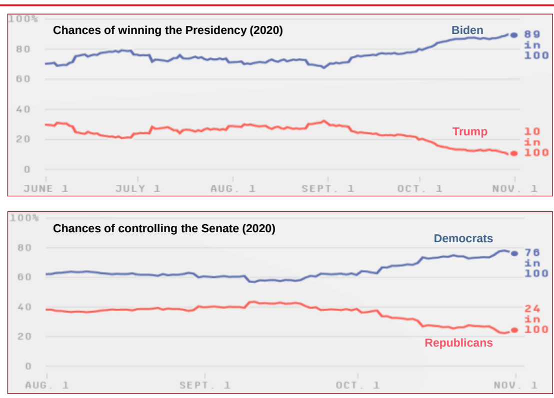


CIO Office (data via Refinitiv).

That being said, with American voters going to the polls tomorrow, investors will soon have one less reason to waver as we will finally know the colour – Republican Red or Democrat Blue – of the ruling party for the next four years.

One day before the election, an in-depth analysis of state polls conducted by FiveThirtyEight suggests a blue sweep is the most likely scenario, with a probability of a Biden victory and the Senate passing to the Democrats with 89% and 76%, respectively (Chart 2).

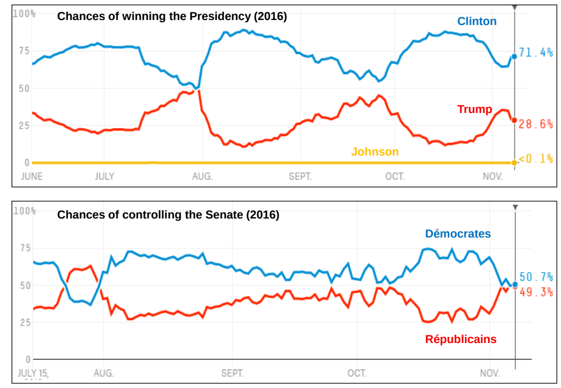
2 A *blue sweep* **is the most likely scenario…**



CIO Office (data via FiveThirtyEight). As of November 1, 2020.

Of course, polls are not flawless. And while there are some valid reasons to believe they better reflect reality now than in 2016[1] (FiveThirtyEight gave Clinton a 71% chance of victory on election day in 2016, Chart 3), these figures do not allow for anything to be taken for granted.

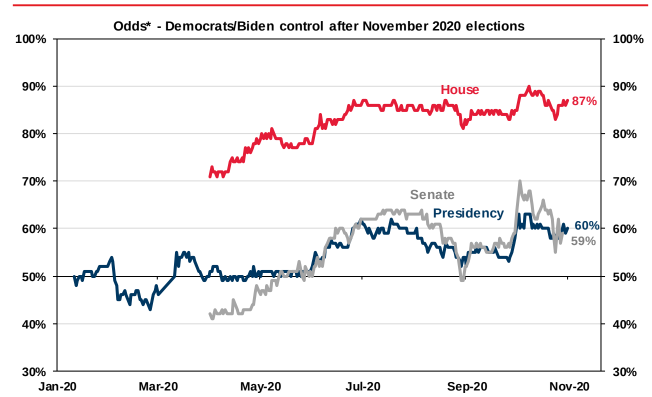
3 **… but with 2016 still a fresh memory…**



CIO Office (data via FiveThirtyEight).

With that in mind, odds observed in the betting markets – arguably a better reflection of what is discounted in financial markets – suggest a much closer race: a 60% chance of victory for Biden and 59% for the Democrats in the Senate (Chart 4). The tighter the results on election night, the greater the risk that we may have to wait a few days (if not more)[2] before definitive results emerge. It goes without saying that such a scenario would not help ease investor anxiety.

4 .. the race remains tighter in betting markets



CIO Office (data via *Predictit).

Looking beyond the potential for short-term turbulence, it is important to reiterate that we expect the nascent bull market to steam ahead over the medium term, regardless of tomorrow's outcome. If we look at stock market performance six months after all Presidential elections since 1980, we find what the only two negative years (2000 and 2008) had in common was not the colour of the winning party (red in 2000, blue in 2008), but the fact that we were in the early stages of a

[1] So what if Biden is up in the polls? Weren't they wrong last time? Reuters, October 29, 2020.

[2] How mail-in voting could delay results in the U.S. election for days – or weeks. CBC, October 28, 2020.

recession[3] (Chart 5). Since neither Presidential candidate is likely to completely halt the ongoing global economic recovery with his policy agenda, neither should have an outsized impact on the direction of equity markets over the next six to twelve months.

5 For equities, the President is not the Commander-in-Chief

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

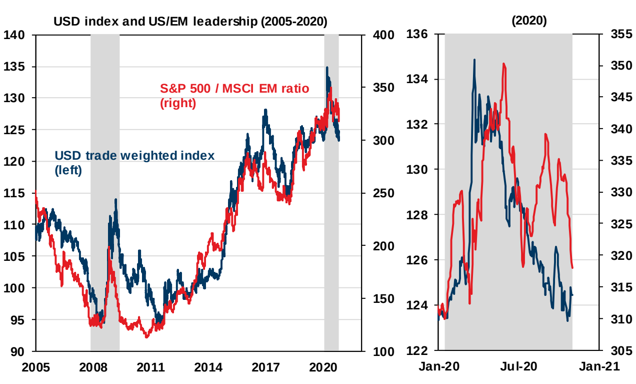
Election Year	President-elect's Party	3-months before	3-months after	6-months after	12-months after
2020*	?	0.4%	?	?	?
2016	R	-1.3%	7.8%	13.3%	23.7%
2012	D	3.0%	6.5%	14.5%	26.8%
2008	D	-19.0%	-16.6%	-8.4%	6.9%
2004	R	2.6%	6.0%	3.7%	9.4%
2000	R	-2.9%	-6.1%	-11.2%	-21.0%
1996	D	8.8%	9.5%	17.4%	34.5%
1992	D	-0.4%	7.2%	6.8%	13.4%
1988	R	2.9%	9.5%	13.2%	27.2%
1984	R	5.8%	7.5%	7.3%	16.7%
1980	R	5.5%	1.4%	5.7%	3.3%
Average		0.5%	3.3%	6.2%	14.1%
Positive / Total		6/10	8/10	8/10	9/10

*since July 31, 2020.

CIO Office (data via Refinitiv).

This doesn't mean markets are completely agnostic to the election results. One asset we will be watching closely is the U.S. dollar. A Democrat sweep would spell large fiscal deficits over the next few years as well as the easing of trade tensions and tariff threats – two bearish elements for the Greenback. Combined with the fact that U.S. businesses would have to discount higher taxes (21% to 28%), this scenario points to an acceleration of emerging-market leadership (Chart 6). Following this logic, a Trump victory would likely see the U.S. currency and stock market dominate those of their peers, much like in November 2016.

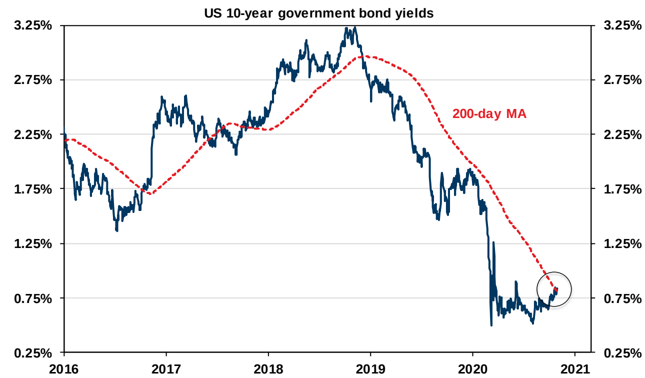
6 Keeping an eye on the dollar and emerging markets



CIO Office (data via Refinitiv).

The other macro variable we will be closely monitoring is yields on U.S. 10-year Treasuries. Despite October's turbulence in the stock market, bond yields rose by 17 bps last month, testing their 200-day moving average for the first time in nearly two years (Chart 7).

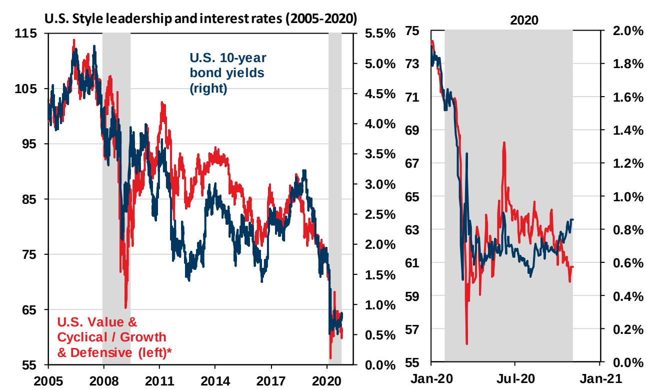
7 Upward pressure on 10-year rates in October...



CIO Office (data via Refinitiv).

Given the Federal Reserve's recent shift to an average inflation target, Treasury yields' upside potential appears relatively limited whereas the likelihood of rate hikes remains remote. Nonetheless, the prospect of an aggressive fiscal stimulus package in the event that Democrats take over the Senate (no matter who the President is) could certainly push 10-year yields higher via a rise in inflation expectations. This backdrop could give some luster back to stocks with more cyclical and value-oriented characteristics (Chart 8).

8 ... another trend to follow closely post-election



CIO Office (data via Refinitiv). *Ratio between average of S&P 500 typical value & cyclical sectors (Financials, Energy, Materials, Cons. Discr., Industrials, Real Estate) and typical growth & defensive sectors (Tech, Health care, Comm svs, Utilities, Staples)

In any event, election results will only provide partial answers to the many questions which have left markets hesitant in recent months. More specifically, two other points must be clarified for the stock market recovery to move to the next level: (1) when will a fiscal stimulus package be passed and, most importantly, (2) when will a more permanent solution to the pandemic be introduced?

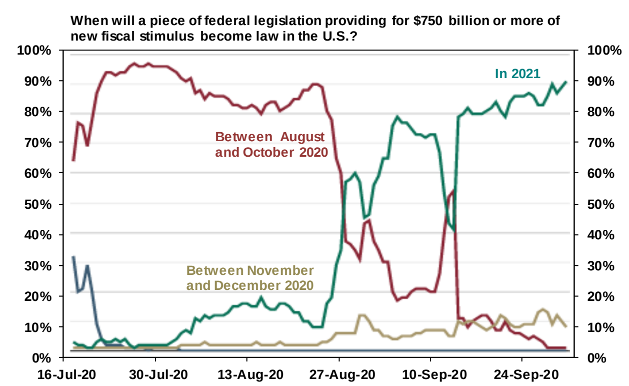
2020 or 2021?

While the election is November 3, it is only on January 3 that the new Congress will commence, and on January 6 when it will formally declare the victory of the President-elect whose

[3] The recession under Obama (November 2008 election) officially began in December 2007 but the worst quarters were Q4-2008 and Q1-2009. The recession under Bush (November 2000 election) officially started in March 2001.

inauguration will take place on January 20. What does this all mean? That some form of political wrangling between Democrats and Republicans over the passage of a fiscal stimulus package should continue for at least another three months (the so-called lame-duck session). That's why any large-scale stimulus package is unlikely to be voted on before 2021 (Chart 9).

9 Fiscal stimulus will likely have to wait until 2021

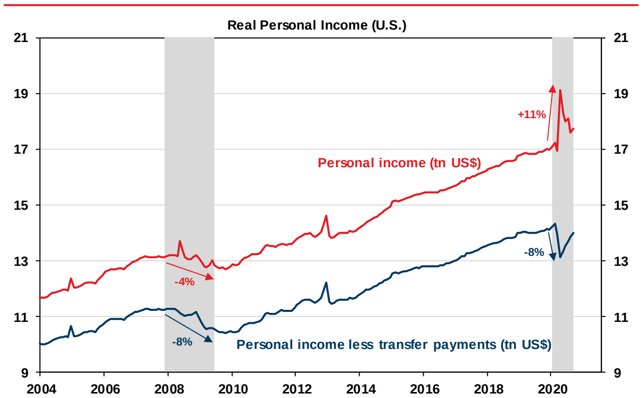


CIO Office (data via goodjudgment.io/superforecasts/#1338). As of October 30, 2020.

If Democrats win the Senate, markets should manage to cope with this delay without too much trouble by discounting the imminence (early February) of a major fiscal stimulus. Rather, the risk is one of a marked deterioration in economic activity between now and the end of the year combined with a Senate left in the hands of fiscally conservative Republican Senators. To be clear, Republicans would also end up passing new aid measures, but their scale may disappoint markets.

Meanwhile, the jump in real personal income following generous government transfers earlier this year provides some cushion. But with the expansion of unemployment benefits having expired since July, this cushion is gradually losing its comfort level (Chart 10).

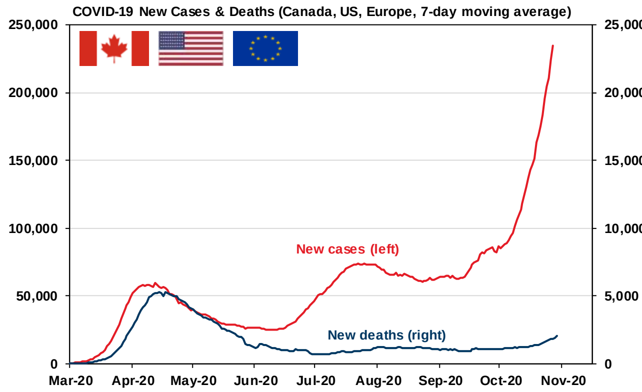
10 U.S. households have some cushion... for now



CIO Office (data via Refinitiv, FRED).

Ultimately, the big question for investors is neither the size nor the timing of the fiscal stimulus, but whether a permanent solution to the pandemic – the very reason we need government support – is on the horizon. This is even greater since the increase in COVID-19 cases has forced several European countries to announce new containment measures in October (Chart 11).

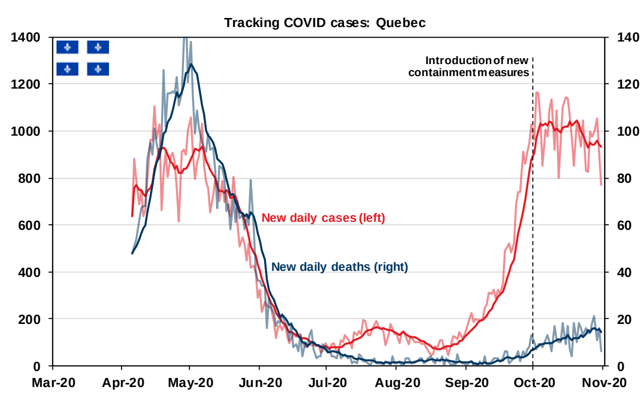
11 **COVID-19: new containment measures in Europe...**



CIO Office (data via Johns Hopkins University).

For now, these measures remain in line with our base-case scenario calling for the use of more targeted restrictions (i.e. less damaging for the economy), not a return to the total lockdown of early 2020. Besides, the new European measures shares similarities with those announced by the Quebec government earlier in October: four weeks of closure for restaurants, bars, cinemas, gyms, and restrictions on gatherings, all while keeping most businesses and schools open. The silver lining is that this approach appears to have had some success in the Province as cases have since stabilized and have even begun to edge lower (Chart 12).

12 **...** similar to those introduced in Quebec in early October



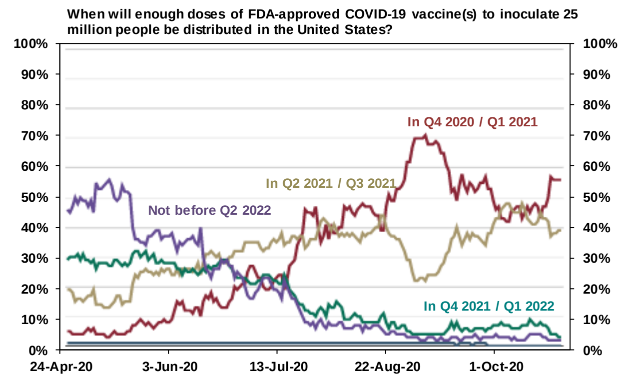
CIO Office (data via Institut national de santé publique du Québec). En date du 31 octobre 2020.

Moreover, in the words of Dr. Fauci, "*we will know whether a vaccine is safe and effective by the end of November, beginning of December.*"[4] While it is impossible to know for certain whether news will be positive, recent reports seem

[4] Hopes are rising for a potential Covid vaccine – and Fauci says findings will be known by early December. CNBC, October 26, 2020.

somewhat promising, as reflected in the increased likelihood a vaccine will be available by the end of Q1 2021 (Chart 13). To be continued…

13 Progress in vaccine research continues



CIO Office (data via goodjudgment.io/superforecasts/#1338). As of October 30, 2020.

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 slightly.**
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 updated: Octobre 1, 2020 (updated quarterly). *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%	-	61.0%	1.0%	-	-	
Alternatives	0%	-	7.0%	7.0%	-	-	
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%	33%	-2.2%	Geographical mix in line with the recommendations of our quantitative trend model. We expect emerging markets to be the major beneficiaries of the weakening U.S. dollar environment, while U.S. equities should benefit from a sector allocation with a growth bias. To diversify against a potentiel style rotation, we favour the quality style and the equal weight index in the U.S.
United States	21%	35%	22.5%	1.5%	37%	1.9%	
EAFE	12%	20%	11.0%	-1.0%	18%	-2.0%	
Emerging markets	6%	10%	7.5%	1.5%	12%	2.3%	
Alternatives							
Inflation Protection	0%	0%	2.0%	2.0%	29%	28.6%	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%	5.0%	5.0%	71%	71.4%	
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%	-	27.5%	6.5%	-	-	
Euro	5%	-	4.2%	-0.4%	-	-	
Japanese Yen	3%	-	2.8%	-0.3%	-	-	
British Pound	2%	-	1.5%	-0.1%	-	-	
Others	9%	-	10.0%	1.3%	-	-	

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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