NATIONAL BANK INVESTMENTS

ASSET ALLOCATION STRATEGY

February 2020

Inflection Point

Highlights

> The first month of the new decade featured a whole host of surprises, starting with a sharp escalation in tensions in the Middle East following an air strike against Iran's top military leader on January 3. Soon after the dust settled, yet another unpredictable event – the coronavirus outbreak – shook markets.

> These market fluctuations prompted us to make some changes to our asset mix on January 28; selling a fraction of our bond allocation and deploying the extra cash in favour of equity markets. We also started building an overweight position in emerging markets.

> There are three main reasons for this move. First, the overall picture has continued to improve since we moved from neutral to modestly overweight equities in October 2019. The U.S.-China trade agreement was officially signed last month – suggesting that trade tensions should no longer be the key risk factor until at least the U.S. presidential elections in November – and global growth has started to pick up. What's more, the Federal Reserve clarified its intention to keep an easy monetary policy until it sees a "really significant move up in inflation that's persistent", effectively cancelling out any chances of rates hikes in the medium-term.

> The second element motivating our move was the equity pullback triggered by the fear surrounding the spread of the coronavirus, that led our Market Sentiment Indicator to edge away from "excessive optimism" levels. Could the Wuhan virus scare worsen and lead to a more pronounced market correction? It's possible. Much uncertainty remains and it is likely that we haven't yet seen the peak in news flow around the outbreak. However, one main lesson can be drawn from the few recent episodes of disease outbreaks: they generally have a limited and temporary market impact.

> Finally, the third reason behind our tactical move to reduce bonds and increase our equity allocation is due to January's sharp retreat in government bond yields (i.e. rally in prices) which seems overdone given the current circumstances.

> Turning to emerging markets, our GRT Model has signaled a leadership shift in favour of Emerging Markets (EM) in recent weeks. The region is likely to remain volatile until the coronavirus situation stabilizes, but we view the recent pullback as an opportunity to start adding to EM assets, which should benefit from easy monetary policies and a pick-up in global growth in 2020. Of course, this means that the significant emergency measures put in place in China will have to bear fruit sooner rather than later.

> The risk-off mood of late January was also felt in the foreign exchange market, with the Canadian dollar starting 2020 on a sour note. But beyond investors' risk appetite, January's Bank of Canada (BoC) policy statement was key in pushing the loonie lower, as markets interpreted its wording as an indication that the BoC could opt for a rate cut in the near future. Although this scenario can't be ruled out, it would be surprising to see such a move before the end of Poloz's term in June given current economic fundamentals. This means that the Canadian dollar has the potential to quickly regain the ground lost in January, but we don't expect it to break out of to the relatively narrow range of the recent months.

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

- Both U.S. and Canadian yields fell sharply in January, depressed in part by falling inflation expectations and a flight to safety in the latter part of the month following the coronavirus outbreak.
- As such, the FTSE/TMX Overall Universe began the new decade outperforming all four major equity geographies.
- The riskier High-Yield market fared less well though, as spreads against 10-year U.S. treasuries had widened by 40 bps by the end of the month.

Canadian Equities

- Canada's S&P/TSX weathered public health-related fears somewhat better than its peers in January, finishing the period as the top performing equity region.
- Stunning growth from the likes of Shopify helped solidify Information Technology as the index's best performing sector last month.
- On the other end of the return spectrum, Canada's second largest sector by market capitalization, Energy, was weighed down by a fall in global oil prices.

U.S. Equities

- The S&P 500 began the new decade with a fizzle instead of a bang, as a 3.5% gain was quickly erased over the final days of January.
- Tail winds in the form of a newly minted "Phase One" trade deal between the U.S. and China as well as growing signs of an earnings rebound in corporate America helped drive the early rise in equities.
- The reversal was largely a response to growing investor uncertainty surrounding the potential economic impact that the coronavirus could have on Chinese and world growth.
- Unsurprisingly, and mirroring the Canadian experience, Energy and Materials sectors were hit the hardest, as the turmoil depressed commodity prices.

Commodities

- A flare-up in Iran-American tensions at the start of the month was only briefly felt in crude markets.
- Instead, January garnered WTI with the dubious award of worst performing major asset class, as the price of a barrel fell back down to $52 U.S. amid fears of a coronavirus-related global growth slowdown.
- Gold on the other hand, often sought out by investors in times of market turmoil, finished the month as the best performing major asset class, having climbed to its highest level since April 2013 to 1587 $/ounce.

Foreign Exchange

- The risk-off mood of late January was also felt in currency markets, as the loonie, which had started the year near its strongest level since November 2018, depreciated by nearly 2% to finish on its 200-day moving average.
- Weakness in the Canadian dollar could also be attributed to the rising implied probability of a rate cut by the Bank of Canada some time in the near future following changes made to its latest policy statement.

Table 2 Market Total Returns

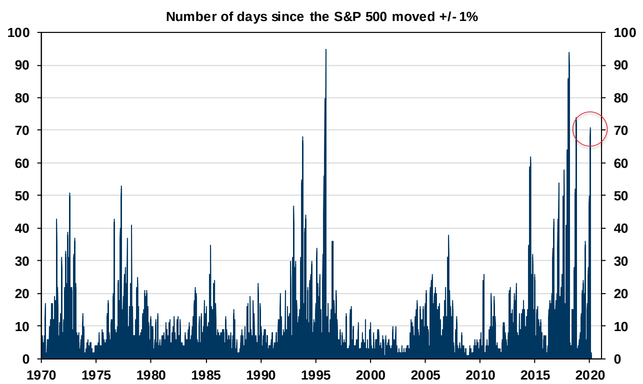
Asset Classes	January	12 months	2019
Cash (3-month T-bills)	0.1%	1.6%	1.6%
Bonds (FTSE CA Ovr. Univ.)	**2.9%**	**8.5%**	**6.9%**
FTSE CA Short term	1.0%	3.5%	3.1%
FTSE CA Mid term	2.9%	7.3%	5.8%
FTSE CA Long term	5.3%	16.1%	12.7%
FTSE CA Government	3.0%	8.3%	6.4%
Federal	2.4%	5.5%	3.7%
Provincial	3.6%	11.1%	9.1%
Municipal	3.3%	10.8%	8.8%
FTSE CA Corporate	2.7%	9.1%	8.1%
AA+	1.4%	5.1%	4.8%
A	3.1%	11.0%	9.6%
BBB	2.9%	10.0%	9.0%
BoAML High-Yield (USD)	0.0%	9.4%	14.4%
Preferred Shares	0.1%	4.1%	3.5%
Canadian Equities (S&P/TSX)	**1.7%**	**15.0%**	**22.9%**
Energy	-2.3%	7.4%	21.7%
Industrials	4.5%	22.1%	25.5%
Financials	2.0%	14.1%	21.4%
Materials	-2.4%	13.3%	23.8%
Utilities	7.7%	39.3%	37.5%
Cons. Disc	-2.4%	1.6%	15.3%
Cons. Staples	4.4%	15.4%	14.4%
Healthcare	-2.5%	-39.4%	-10.9%
IT	9.4%	64.1%	64.9%
Comm. Svc.	2.9%	11.2%	13.0%
REITs	4.7%	18.9%	22.6%
S&P/TSX Small Cap	-2.9%	4.5%	15.8%
US Equities (S&P500 USD)	**0.0%**	**21.7%**	**31.5%**
Energy	-11.1%	-10.5%	11.8%
Industrials	-0.4%	15.6%	29.4%
Financials	-2.6%	18.3%	32.1%
Materials	-6.2%	10.8%	24.6%
Utilities	6.7%	30.3%	26.3%
Cons. Disc	0.6%	16.7%	27.9%
Cons. Staples	0.4%	21.7%	27.6%
Healthcare	-2.7%	12.1%	20.8%
IT	4.0%	46.1%	50.3%
Comm. Svc.	0.9%	21.3%	32.7%
REITs	1.4%	18.1%	29.0%
Russell 2000 (USD)	-3.3%	7.6%	23.7%
World Eq. (MSCI ACWI)	**-1.1%**	**16.7%**	**27.3%**
MSCI EAFE (USD)	-2.1%	12.7%	22.7%
MSCI EM (USD)	-4.7%	4.2%	18.9%
Commodities (CRB index)	**0.6%**	**-2.1%**	**-1.9%**
WTI Oil (US$/barrel)	-15.6%	-4.1%	35.1%
Gold (US$/ounce)	4.4%	20.0%	18.7%
Copper (US$/tonne)	-9.7%	-9.8%	3.4%
Forex (DXY - US Dollar index)	**1.0%**	**1.9%**	**0.2%**
USD per EUR	-1.3%	-3.4%	-1.8%
CAD per USD	1.9%	0.9%	-4.8%

CIO Office (data via Refinitiv) 1/31/2020

Inflection Point

The first month of the new decade featured a whole host of surprises, starting with a sharp escalation in tensions in the Middle East following an air strike against Iran's top military leader on January 3. Soon after the dust settled, yet another unpredictable event – the ongoing coronavirus outbreak – shook markets, this time ending the S&P 500's 71-day streak of relatively calmer days (Chart 1).

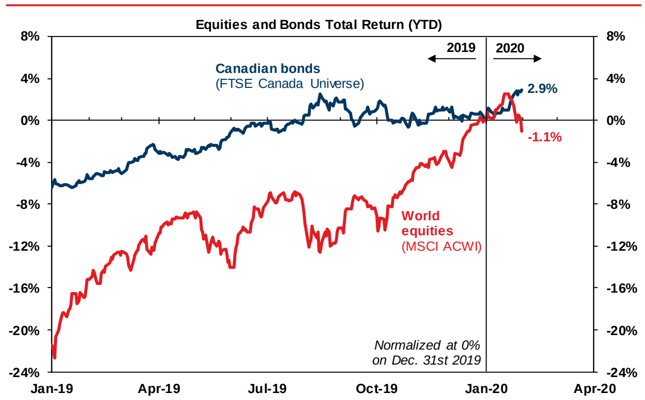
1 End of a prolonged series of calmer days for equities…



CIO Office (data via Refinitiv).

So, where do markets stand after this rather unsettling month of January? Sharply higher for bonds (+2.9% FTSE Canada Bond Universe) and slightly lower for equities (-1.1% MSCI ACWI) (Chart 2).

2 … and a strong start to 2020 for fixed income assets

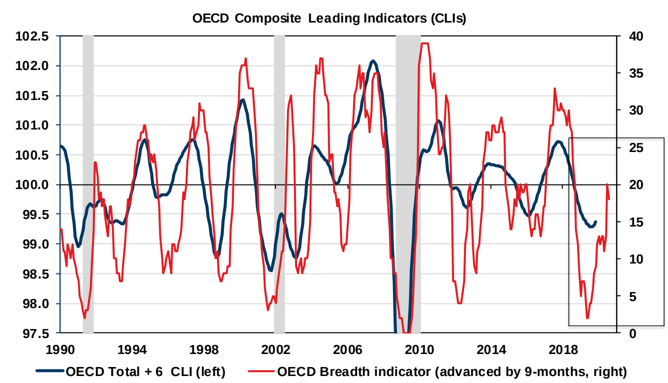


CIO Office (data via Refinitiv).

These market fluctuations prompted us to make some changes to our asset mix on January 28; selling a fraction of our bond allocation and deploying the extra cash in favour of equity markets. We also started building an overweight position in emerging markets.

There are three main reasons for this move. First, the overall picture has continued to improve since we moved from neutral to modestly overweight equities in October 2019. Back then, we described our asset mix change as a first step back into risk assets, to be either increased or reversed depending on how the U.S.-China phase one agreement and global growth would turn out. Well, the trade agreement was officially signed last month – suggesting that trade tensions should no longer be the key risk factor until at least the U.S. presidential elections in November – and global growth has started to turn the corner (Chart 3). What's more, the Federal Reserve clarified its intention to keep an easy monetary policy until it sees a "really significant move up in inflation that's persistent", effectively cancelling out any chances of rates hikes in the medium-term.

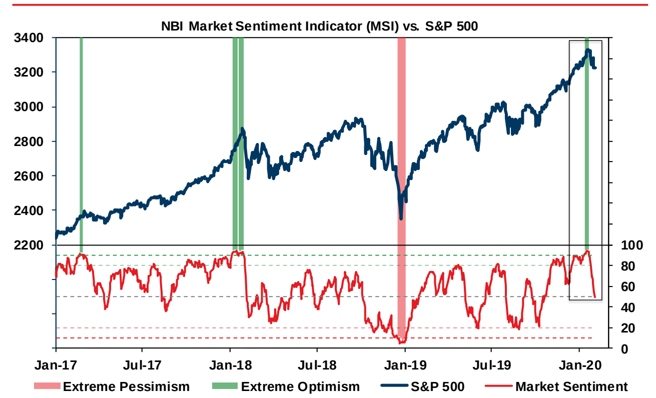
3 Global growth has started to turn the corner



CIO Office (data via Refinitiv).

The second element motivating our move was the equity pullback triggered by the fear surrounding the spread of the coronavirus that led our Market Sentiment Indicator to edge **away from "excessive optimism" levels** (Chart 4).

4 Markets' overconfidence has subsided

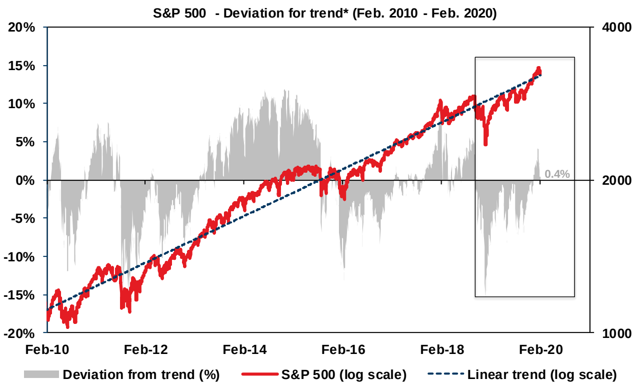


CIO Office (data via Refinitiv).

Admittedly, the actual retreat in equity prices remains fairly limited (-3.1% for the S&P 500 and -7.4% for the MSCI Emerging Market, from January peak to trough). However, in a context where the fundamental economic backdrop continues to move in favour of equities, waiting for the perfect "dip" is a classic trap. Let's not forget that time is money on the stock market, as is so clearly illustrated by the linear trend of U.S. equity returns over the last decade, which we've only just caught up in recent weeks (Chart 5, next page).

As for the coronavirus, could the situation worsen and lead to a more pronounced market correction? It's possible. Much

5 Time & trend play in favour of equities



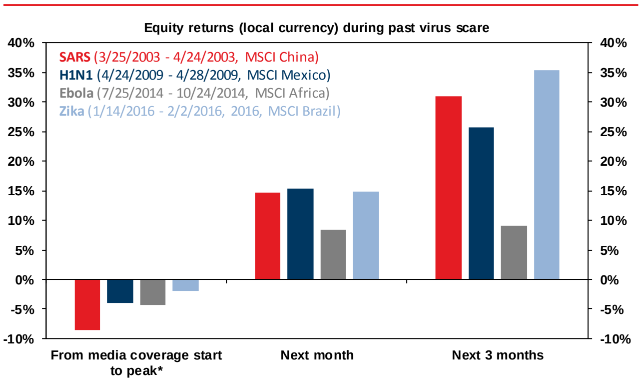
CIO Office (data via Refinitiv). * Linear regression over time of the logarithm of the S&P 500 price index from January 31, 2010 to January 31, 2020.

uncertainty remains and it is likely that we haven't yet seen the peak in news flow around the outbreak. Accordingly, markets should continue to react nervously as the situation evolves. However, there are valid reasons to believe that it won't inflict permanent damage to the ongoing economic expansion.

For instance, the Chinese government has quickly acted and shared information with the World Health Organization (WHO), taking roughly 3 weeks following the first case to do so vs. the 4-5 months it took during the SARS outbreak. Furthermore, the mortality rate (2.07%[1] vs. ~10% for SARS) suggests that the virus generally ends in more fear than harm, while fatalities up to now (362, all but one in China) mostly concern elderly people with pre-existing conditions. For comparison, the WHO pointed that the seasonal flu kills an estimated 400,000 people every year.

Recent history (fortunately) doesn't abound with cases of disease outbreaks, with SARS in 2003, H1N1 in 2009, Ebola in 2014, and Zika in 2016 all having their peculiarities that make them imperfect comparables to the current context. Yet, they all have a common denominator: a limited and temporary market impact (Chart 6).

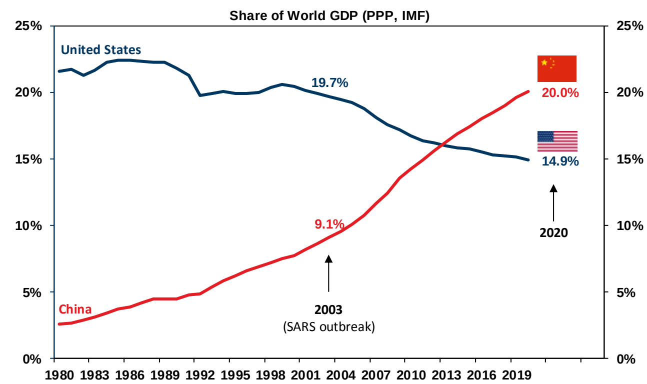
6 Common denominator: a limited market impact



CIO Office (data via Refinitiv, Bloomberg, JP Morgan). * Periods from top to bottom of media coverage according to the number of articles published on Bloomberg.

That said, there's no guarantee that this time won't be different – notably due to the fact that China accounts for a much larger share of the world economy today than it did during the SARS episode of 2003 (Chart 7) – but the extent of the emergency measures put in place together with additional monetary easing by the People's Bank of China suggests that the situation could quickly stabilize.

7 Risk: China's size in the global economy



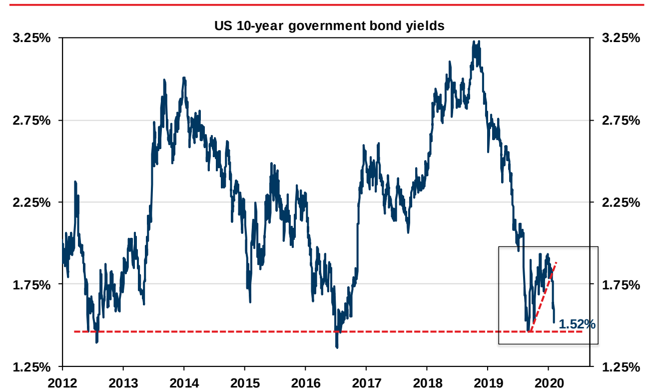
CIO Office (data via Refinitiv).

Finally, the third reason behind our tactical move to reduce bonds and increase our equity allocation is due to **January's** sharp retreat in government bond yields (i.e. rally in prices) which seems overdone given the current circumstances. At these current levels, risk-reward characteristics of bonds are not very compelling, as we discuss in the next section.

Fixed Income: Not so Fast

January featured quite a move in the bond market, with U.S. 10-year Treasury yields falling by 39 basis points and thereby breaking away from the upward trend observed since last September (Chart 8).

8 **Sharp bond yields reaction in January...**



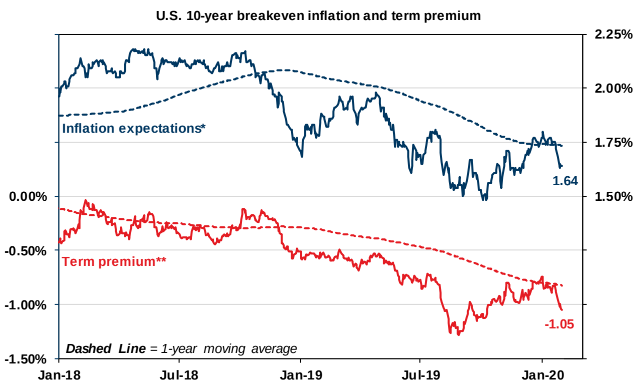
CIO Office (data via Refinitiv).

Heightened risk aversion and global growth concerns has unsurprisingly played a key role in this retreat, with both the 10-year term premium (highly correlated with investor's risk

[1] 362 out of 17491 confirmed cases. February 3 Novel Coronavirus Situation Report (am), World Health Organization

appetite) and breakeven inflation rates (highly correlated with oil prices) falling sharply after attempting a return above their respective 1-year moving averages early in the month (Chart 9).

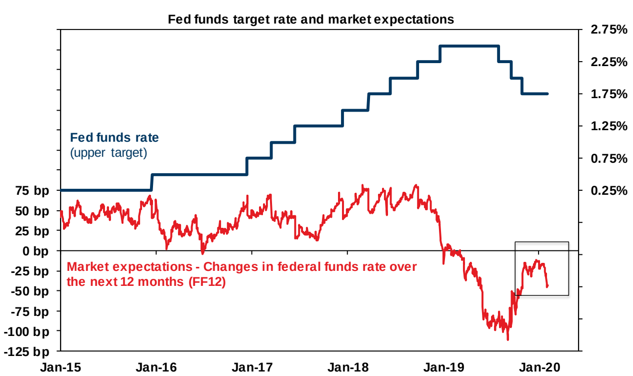
9 ... with inflation^e and term premiums falling sharply...



CIO Office (data via Refinitiv). *10-year breakeven between TIPS and nominal Treasury bonds. ** ACM 10-year term premium estimates.

In parallel, we have also seen markets begin to fully discount almost two rate cuts (45 bps) by the Federal Reserve in 2020 (Chart 10).

10 ... and markets now discounting almost two rate cuts



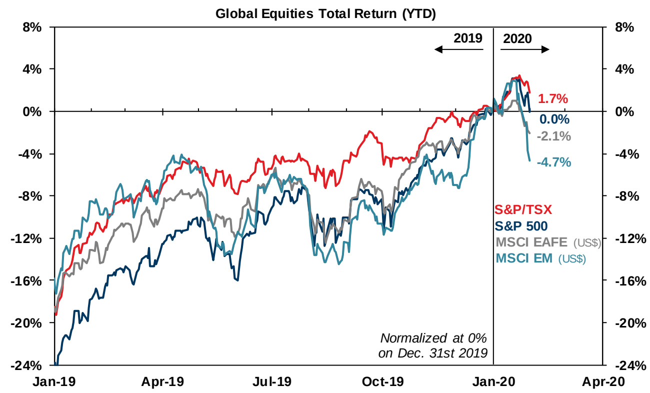
CIO Office (data via Refinitiv).

Are these moves justified? Will the Federal Reserve indeed opt for additional rate cuts amid an environment of sustained risk aversion and falling inflation expectations? We can't rule it out, but we still consider this to be a low-probability alternative scenario rather than an integral part of our baseline scenario. In any case, seeing the Canadian bond market (FTSE Canada Universe) up 2.9% after only one month with an annual yield to maturity of ~2.0% leads us to believe that we're not leaving much return on the table by reducing their allocation.

Equities: Shaken Up

After a strong start in 2020, global equity markets faced their first serious challenge of the year – the coronarivus outbreak – during the last week of January. Their response, however, was mainly in the form of higher volatility, whereas only emerging markets and EAFE equities are showing losses year-to-date (Chart 11).

11 Volatile start to the year for global equities



CIO Office (data via Refinitiv).

Better-than-expected earnings results south of the border have undoubtedly helped to limit the damage to equity markets, especially in the heavy-weighted technology sector (Chart 12).

12 Good first half for Q4/2019 U.S. earnings season...

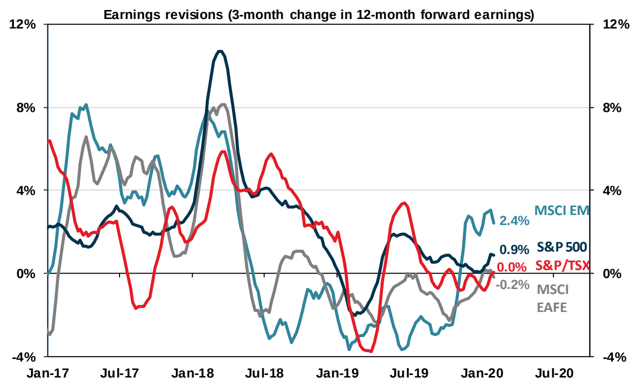
	Earnings Summary - S&P 500				Q4/2019 YoY%
	% Reported	% Beat	% Met	% Missed	Blend*
S&P 500	45%	69%	11%	20%	1.2%
Financials	68%	64%	9%	27%	11.2%
Industrials	64%	64%	9%	27%	-9.7%
Materials	54%	60%	7%	33%	-12.6%
Staples	48%	63%	31%	6%	2.1%
Technology	44%	90%	3%	6%	7.6%
Health Care	42%	72%	16%	12%	8.0%
Energy	36%	50%	0%	50%	-41.3%
Discretionary	30%	84%	5%	11%	-6.6%
Real Estate	29%	44%	44%	11%	3.6%
Comm. Sev.	27%	86%	0%	14%	3.6%
Utilities	14%	50%	0%	50%	13.6%

CIO Office (data via Refinitiv). As of February 2, 2020. *Blends actual EPS growth with expectations for those yet to report.

Likewise, earnings expectations for the next twelve months have started to edge higher – especially in emerging markets (Chart 13, next page) – just as a number of key economic global indicators surprised to the upside in recent weeks (Chart 14, next page). Again, this is especially true in emerging markets (Chart 15, next page).

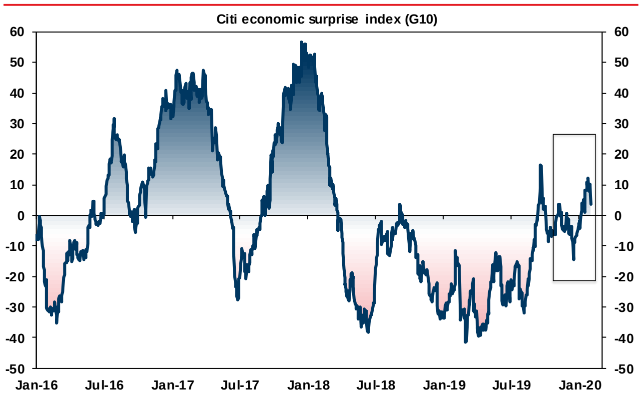
Under these circumstances, we viewed the coronavirus-inflicted pullback in EM equities as an opportunity to start increasing their allocation, fully aware that the uncertainty surrounding the virus outbreak is likely to lead to further volatility until it stabilizes. As we've mentioned previously, EM assets are the most likely candidates to outperform in the context of accelerating global growth and easy monetary policies. A signal of shifting leadership in their favour from our Geographical Relative Trend Model (GRT) was the missing piece to move us from neutral to slightly overweight, and it happened in recent weeks (Chart 16, next page).

13 ... with forward earnings expectations picking up...



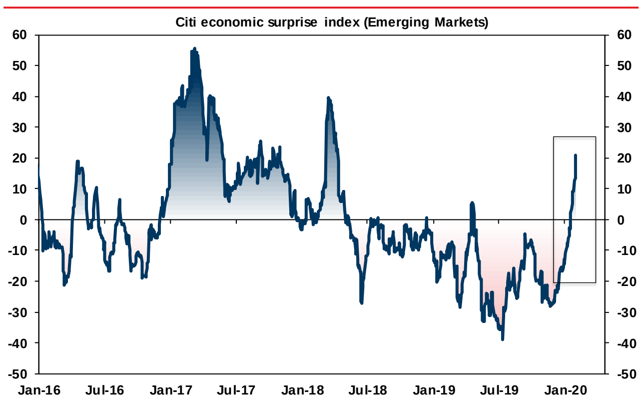
CIO Office (data via Refinitiv).

14 ... and key economic indicators surprising positively...



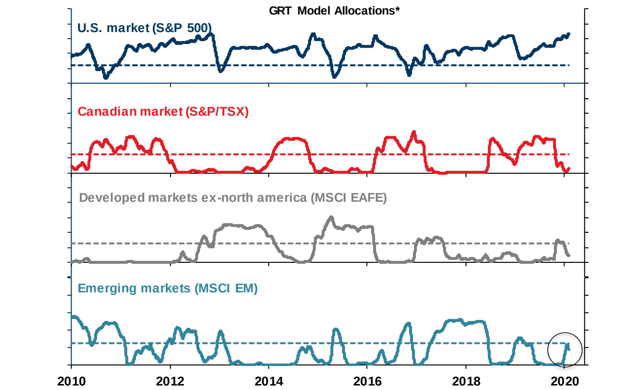
CIO Office (data via Refinitiv).

15 ... especially in emerging markets



CIO Office (data via Refinitiv).

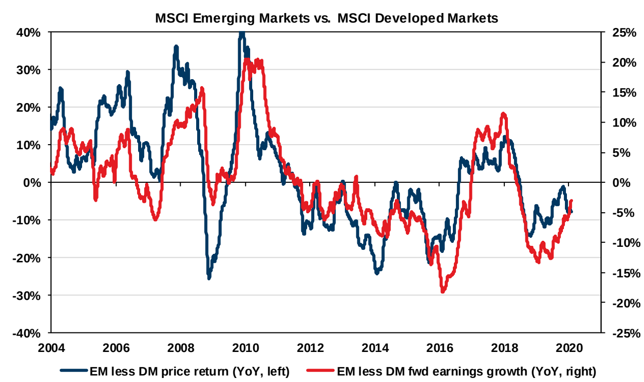
16 Will the signal in favour of EMs strengthen?...



CIO Office (data via Refinitiv). *Equally weighted benchmark.

Now, for emerging markets to substantially outstrip developed markets, the growth differential needs to keep moving in the former's direction, as it has been the case since late 2019 (Chart 17).

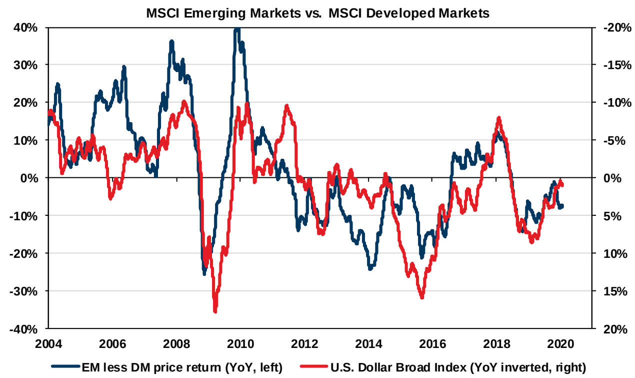
17 ... It depends on the growth differential...



CIO Office (data via Refinitiv).

Of course, this means that the significant emergency measures put in place in China (extension of the New-Year holiday, partial and complete lockdown of multiple cities, travel restrictions) will have to bear fruit sooner rather than later. By the same token, this should allow the counter-cyclical U.S. dollar – a key macroeconomic factor when it comes to EM vs. DM leadership (Chart 18, next page) – to head lower as investors' risk appetite comes back. We will therefore be monitoring the situation closely in the coming days and stand ready to reassess our baseline scenario and asset allocation accordingly should the situation head for the worse.

18 … and the U.S. dollar's direction

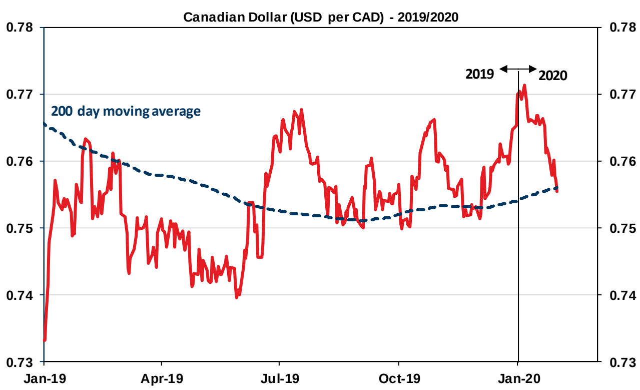


CIO Office (data via Refinitiv).

Currencies: Loss of Altitude for the Loonie

The risk-off mood of late January was also felt in the foreign exchange market, with the Canadian dollar – which tends to correlate positively with risk assets – starting 2020 down 1.8% and right on its 200-day moving average (Chart 19).

19 Loss of altitude for the loonie…

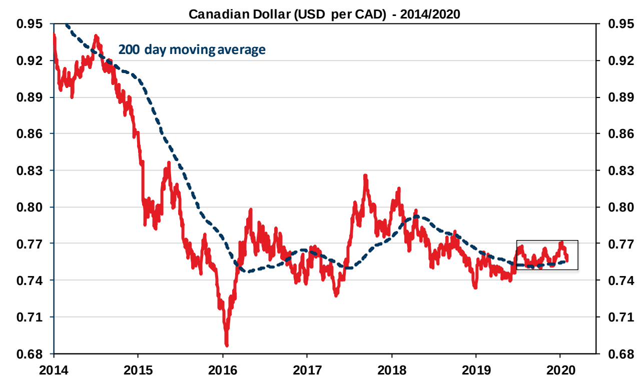


CIO Office (data via Refinitiv).

Beyond investors' risk appetite, the January 22 Bank of Canada (BoC) policy statement was key in pushing the loonie lower. Indeed, while the BoC decided the keep its policy rate unchanged as widely expected, it removed the term "appropriate" when describing its current stance. This seemingly subtle change was interpreted by markets as an indication that it could opt for a rate cut in the near future, depending on how growth and ongoing sources of uncertainty evolve.

BoC Governor Stephen Poloz has accustomed markets to never completely ruling out any scenario. Yet, with core inflation (2.10%) slightly above the mid-point target range and improving global growth, it would be surprising to see the BoC move rates lower before the end of Poloz's term in June. This means that the Canadian dollar has the potential to quickly regain the ground lost in January. That said, we still expect the loonie to remain confined to the relatively narrow range of recent months provided that both the Federal Reserve and the BoC remain at a standstill as projected (Chart 20).

20 … but the direction remains the same: none



CIO Office (data via Refinitiv).

CIO Office
CIO-Office@nbc.ca

Martin Lefebvre
CIO and Strategist
martin.lefebvre@nbc.ca

Simon-Carl Dunberry
Chief Analyst
simon-carl.dunberry@nbc.ca

Louis Lajoie
Principal Analyst
louis.lajoie@nbc.ca

Nicolas Charlton
Analyst
nicolas.charlton@nbc.ca

General

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