ASSET ALLOCATION STRATEGY

March 2020

Coping with COVID-19

Highlights

- Fear gripped markets late in February as the acceleration of new COVID-19 cases outside China raised concerns over its potential ability to inflict a major negative shock to global growth. As a result, U.S. equities have come down 12.8% from their all-time high, officially marking the first market correction since December 2018.
- Could the Coronavirus outbreak escalate and trigger a more serious downturn? As we are neither microbiologists, pandemic specialists, nor soothsayers, the best we can do to answer this question is to look objectively at the currently available information coming out of the World Health Organization.
- A key factor that we observe is that the number of infected people in China has been plateauing and the recovering cases increasing in recent weeks, an indication that the virus can be contained if adequate measures are enforced. However, things did get more complex in late February, as we learned the number of cases outside China was rapidly increasing. If this trend persists, as it appears to be doing, consequences will undeniably be more serious and longer lasting than we previously estimated in light of the information available a month ago.
- This, therefore, leaves us in an uncomfortable position where a look in the rear-view mirror shows a series of fundamental reasons for equities to outperform, but the rapid materialization of one of the key risks to our economic outlook blurs nearly all visibility in the near term.
- Consequently, we believe that the necessary decision in this context of rapidly rising risks was to move to a more cautious tactical asset mix. Therefore, we reduced our allocation in equities to neutral on February 26, and increased our positions in fixed income (although we remain underweight) and cash.
- To be clear, our shift to a more cautious stance on risk assets is tactical (i.e. short-term horizon), whereas investors should avoid making drastic changes to their strategic (i.e. long-term horizon) asset allocation in the midst of a storm – especially since we continue to view the fundamental economic and monetary backdrop as supportive of equities over a longer investment horizon. The economic impact of a pandemic remains transitory by definition, and we should not underestimate governments and central banks' capacity to rapidly announce stimulative measures.
- Within equities, we reduced emerging markets (EM) back to neutral. With global economic activity under pressure, safe-haven demands likely to keep the U.S. dollar strong in the near-term, and a decline in our GRT model recommendation, a slight reduction in their tactical allocation was warranted until new data allows for a better assessment of fundamentals.
- Nearly all of the boxes are checked for the Federal Reserve to lower its policy rate at its next meeting on March 18, which it will most likely do. The Bank of Canada should also announce a lower policy rate at its next meeting this Wednesday (March 4). What will lower rates do to resolve a virus outbreak? Not much, except to ease pressure on financial markets until the spread of the disease runs its course. But once things get back to normal, easier monetary conditions should support a quick recovery in economic activity.

Table 1 Global Asset Allocation

Global Classes	−		Weights		+
Cash			Previous	Current	
Fixed Income		Current			
Equities			Current	Previous	
Fixed Income					
Federal		Current			
Investment Grade			Current		
High Yield (USD)			Current		
Non-Traditional FI				Current	
World Equities					
S&P/TSX			Current		
S&P 500 (USD)				Current	
MSCI EAFE (USD)		Current			
MSCI EM (USD)			Current	Previous	
Factors and Alternative Investments					
Value vs. Growth			Current		
Small vs. Large			Current		
Low Vol. vs. High Beta			Current		
Canadian Dollar			Current		
Commodities				Current	
Energy				Current	
Base Metals				Current	
Gold			Current		
Infrastructure			Current		

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Current Allocation

Previous Allocation

Market Review

Fixed Income

- Coming off a strong January, fixed-income products again delivered positive returns in February, as one of only a few asset classes to weather the risk-off selloff.
- The 30-year and 10-year U.S. Treasury yields closed out the month at record lows, amid increasing fears of a global economic slowdown should the number of Coronavirus cases outside of China continue to accelerate.
- High-yield bonds fared less well than their safer counterparts, as rising risk aversion pushed credit spreads to widen.

Canadian Equities

- The impact of Coronavirus-related fears on the S&P/TSX was compounded by a further weakening in oil prices last month, as Canadian equities suffered their first monthly decline since last November.
- No sector was spared, as they all finished the month negative, but the defensive Utilities sector kept losses to a minimum.
- The ever-volatile and marijuana-flavoured Canadian Healthcare sector once again picked up this month's dubious honour of worst performer, dropping by double digits.

U.S. Equities

- Market sentiment took a turn for the worse in late February, with the S&P 500 suffering its worst 5-day drop since August 2011.
- An acceleration in new Covid-19 cases outside of China as well as worrying preliminary PMI data sparked the heavy selloff, leading every sector to post negative returns over the month.
- Mirroring its neighbour to the north, the Energy sector suffered the most, more than doubling its year-to-date losses.

Commodities

- Commodity prices fell in line with demand expectations as parts of the Chinese economy ground to a halt following measures designed to contain Covid-19's spread.
- One key victim of this slowdown was oil prices, as the WTI fell for a second straight month to its lowest level since January 2019.
- For their part, gold prices surged early in February as investors piled into the asset in search of safety. However, the last day of February saw the precious metal erase all its monthly gains as margin calls likely forced many speculators to sell the winning commodity to offset sharp losses elsewhere.

Foreign Exchange

- A late and sudden increase in the market-implied odds of rate cuts south of the border were unable to halt the Greenback's rise last month, its safe-haven properties taking precedence in the current environment.
- The Loonie ended February at a six-month low, having depreciated throughout the period in response to falling commodity prices and the prospect of weaker demand for Canadian goods should a global economic slowdown materialize.

Table 2 Market Total Returns

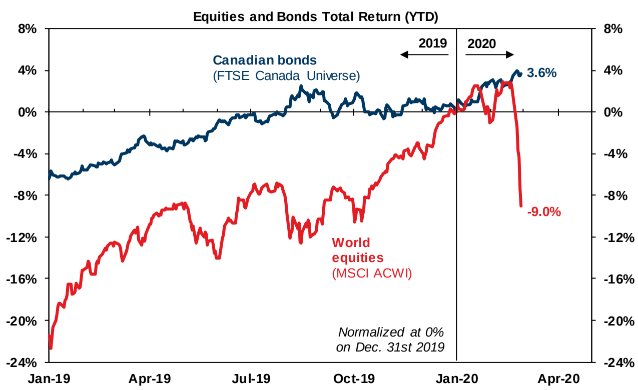
Asset Classes	February	YTD	12 months
Cash (3-month T-bills)	0.2%	0.3%	1.7%
Bonds (FTSE CA Ovr. Univ.)	**0.7%**	**3.6%**	**9.1%**
FTSE CA Short term	0.7%	1.7%	3.9%
FTSE CA Mid term	0.8%	3.8%	8.0%
FTSE CA Long term	0.7%	6.0%	16.7%
FTSE CA Government	0.8%	3.8%	9.0%
Federal	1.1%	3.4%	6.6%
Provincial	0.6%	4.2%	11.4%
Municipal	0.5%	3.9%	10.9%
FTSE CA Corporate	0.4%	3.1%	9.2%
AA+	0.6%	2.0%	5.3%
A	0.3%	3.5%	11.2%
BBB	0.4%	3.3%	10.0%
BoAML High-Yield (USD)	-1.6%	-1.6%	5.9%
Preferred Shares	-3.4%	-3.3%	-1.5%
Canadian Equities (S&P/TSX)	**-5.9%**	**-4.3%**	**4.9%**
Energy	-7.1%	-9.2%	-4.8%
Industrials	-6.3%	-2.1%	10.5%
Financials	-5.3%	-3.4%	4.9%
Materials	-7.6%	-9.8%	5.5%
Utilities	-2.6%	4.9%	29.9%
Cons. Disc	-7.3%	-9.6%	-6.1%
Cons. Staples	-6.0%	-1.8%	4.9%
Healthcare	-16.7%	-18.7%	-50.5%
IT	-2.6%	6.6%	47.4%
Comm. Svc.	-6.8%	-4.1%	1.0%
REITs	-3.3%	1.2%	9.6%
S&P/TSX Small Cap	-9.9%	-12.5%	-9.4%
US Equities (S&P500 USD)	**-8.2%**	**-8.3%**	**8.2%**
Energy	-14.6%	-24.0%	-25.5%
Industrials	-9.3%	-9.7%	-1.5%
Financials	-11.2%	-13.5%	2.5%
Materials	-8.4%	-14.0%	-1.7%
Utilities	-9.9%	-3.9%	12.7%
Cons. Disc	-7.6%	-7.0%	7.1%
Cons. Staples	-8.1%	-7.8%	9.4%
Healthcare	-6.7%	-9.2%	3.4%
IT	-7.3%	-3.6%	26.7%
Comm. Svc.	-6.3%	-5.5%	12.7%
REITs	-6.3%	-5.0%	9.4%
Russell 2000 (USD)	-8.5%	-11.5%	-6.3%
World Eq. (MSCI ACWI)	**-8.0%**	**-9.0%**	**4.5%**
MSCI EAFE (USD)	-9.0%	-10.9%	0.0%
MSCI EM (USD)	-5.3%	-9.7%	-1.5%
Commodities (CRB index)	**-2.2%**	**-1.6%**	**-4.3%**
WTI Oil (US$/barrel)	-13.2%	-26.7%	-21.8%
Gold (US$/ounce)	0.0%	4.4%	20.6%
Copper (US$/tonne)	1.2%	-8.6%	-14.3%
Forex (DXY - US Dollar index)	**0.8%**	**1.8%**	**2.0%**
USD per EUR	-0.9%	-2.1%	-3.5%
CAD per USD	1.2%	3.2%	1.8%

CIO Office (data via Refinitiv) 2020-02-28

Coping with COVID-19

Fear gripped markets late in February, with world equities now down 9.0% and Canadian bonds up 3.6% so far this year, as the acceleration of new COVID-19 cases outside China raised concerns over its potential ability to inflict a major negative shock to global growth (Chart 1).

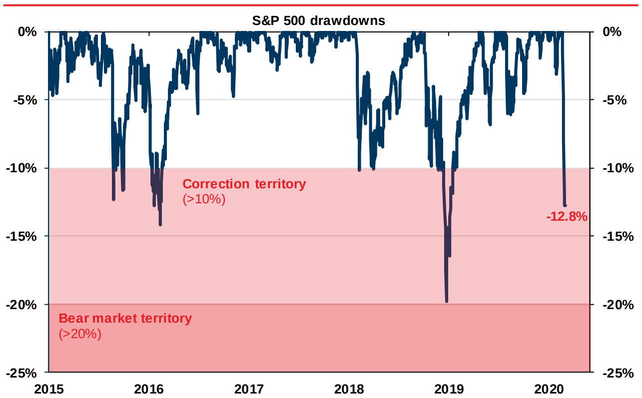
1 Sharp market reaction to the Coronavirus in February...



CIO Office (data via Refinitiv).

This sharp market reaction to rapidly evolving risks has brought the U.S. equity market down 12.8% from its February 19 record high, officially marking the first market correction since December 2018 (Chart 2).

2 ... resulting in the first equity correction since 2018



CIO Office (data via Refinitiv).

First and foremost, it is important to keep in mind that volatility and market corrections are part and parcel of equity investments. For instance, since 1990 the U.S. stock market has experienced an average annual maximum drawdown of 13.8%, in spite of finishing higher 24 out of 29 years and by an average of +11.5%. At the moment, the S&P 500's 12.8% retreat from its all-time high is not out of historical norms per se (Chart 3).

Now, this does not mean that we shouldn't question the potential for the situation to worsen, and while our market sentiment indicator does suggest growing odds of a rebound in the short term (as in June 2019, August 2019, October 2019), we may also have to reach extreme levels before seeing a sustained recovery (as in December 2018) (Chart 4).

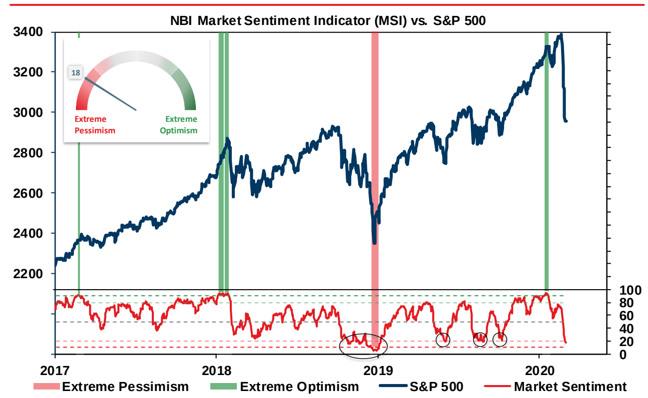
3 Corrections are part and parcel of equity investments

S&P 500 total return and corrections since 1990

	Total Return	Maximum Drawdown	# of 5% corrections	# of 10% corrections	# of 20% corrections
2020 YTD	-8.3%	-12.8%	2	1	0
2019	31.5%	-6.8%	2	0	0
2018	-4.4%	-19.8%	8	3	0
2017	21.8%	-2.8%	0	0	0
2016	12.0%	-10.5%	3	1	0
2015	1.4%	-12.4%	3	1	0
2014	13.7%	-7.4%	2	0	0
2013	32.4%	-5.8%	1	0	0
2012	16.0%	-9.9%	2	0	0
2011	2.1%	-19.4%	10	1	0
2010	15.1%	-16.0%	5	1	0
2009	26.5%	-27.6%	11	3	1
2008	-37.0%	-48.8%	24	8	3
2007	5.5%	-10.1%	4	1	0
2006	15.8%	-7.7%	2	0	0
2005	4.9%	-7.2%	2	0	0
2004	10.9%	-8.2%	3	0	0
2003	28.7%	-14.1%	4	1	0
2002	-22.1%	-33.8%	14	4	1
2001	-11.9%	-29.7%	11	5	1
2000	-9.1%	-17.2%	12	3	0
1999	21.0%	-12.1%	6	1	0
1998	28.6%	-19.3%	6	3	0
1997	33.4%	-10.8%	4	1	0
1996	23.0%	-7.6%	1	0	0
1995	37.6%	-2.5%	0	0	0
1994	1.3%	-8.9%	2	0	0
1993	10.1%	-5.0%	0	0	0
1992	7.6%	-6.2%	2	0	0
1991	30.5%	-5.7%	4	0	0
1990	-3.1%	-19.9%	6	3	0
Average	11.5%	-13.8%	5.1	1.3	0.2

CIO Office (data via Refinitiv)

4 Will it get worse before it gets better?

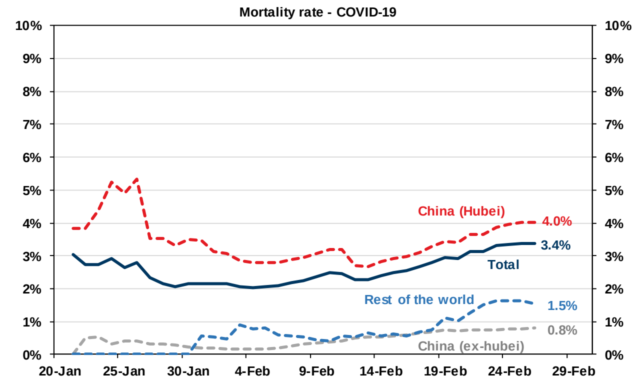


CIO Office (data via Refinitiv).

So, could the Coronavirus outbreak escalate and trigger a more serious downturn? As we are neither microbiologists, pandemic specialists, nor soothsayers, the best we can do to answer this question is to look objectively at the currently available information coming out of the World Health Organization.

A first factor that we observe is that the mortality rate remains relatively stable; between 2% to 4% in the Hubei province and below 2% elsewhere (Chart 5, next page). These figures remain below the fatality rate of the 2002/03 SARS (~10%) and 2012

5 COVID-19: the mortality rate remains relatively stable…

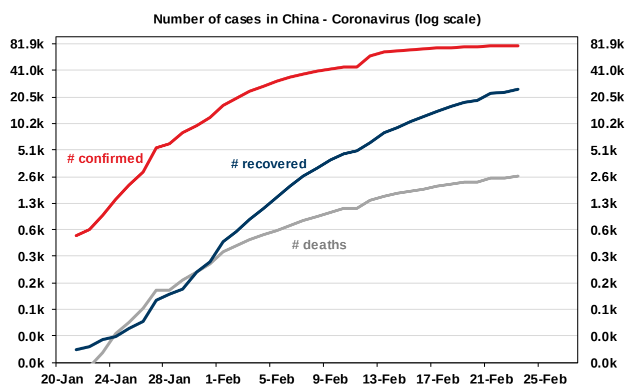


CIO Office (data via WHO). github.com/CSSEGISandData/COVID-19/. As of February 27, 2020.

MERS (~34%) but are above that of the 2009 H1N1 (~0.02%) and seasonal flu (~0.1%).

A second observation is that the number of infected people in China has been plateauing and the recovering cases increasing in recent weeks, an indication that the virus can be contained if adequate measures are enforced (Chart 6). In and of itself, this represents a rather encouraging development.

6 … and the situation is stabilizing in China…

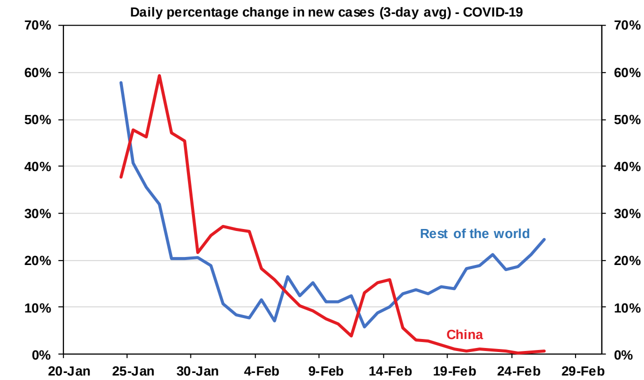


CIO Office (data via WHO). github.com/CSSEGISandData/COVID-19/. As of February 27, 2020.

However, things did get more complex in late February, as we learned that the number of cases outside China – namely in Italy, South Korea, and Iran – was rapidly increasing (Chart 7). If this trend persists as it appears to be doing, consequences will undeniably be more serious and longer lasting than we previously estimated in light of the information available a month ago.

Under these trying circumstances, the WHO Director General, Dr. Ghebreyesus, emphasized on February 24 that COVID-19 was not yet a pandemic as "*we are not witnessing the uncontained global spread of this Coronavirus, and we are not witnessing large-scale severe disease or death.*"[1] To his point, data does show that the vast majority (94%) of cases remain in

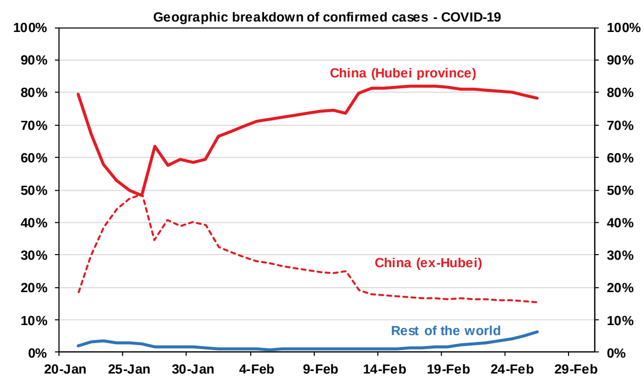
7 … but contagion is increasing elsewhere in the world



CIO Office (data via WHO). github.com/CSSEGISandData/COVID-19/. As of February 27, 2020.

China (Chart 8), but the likelihood of a pandemic is undeniably on the rise.

8 The vast majority of cases remain in China



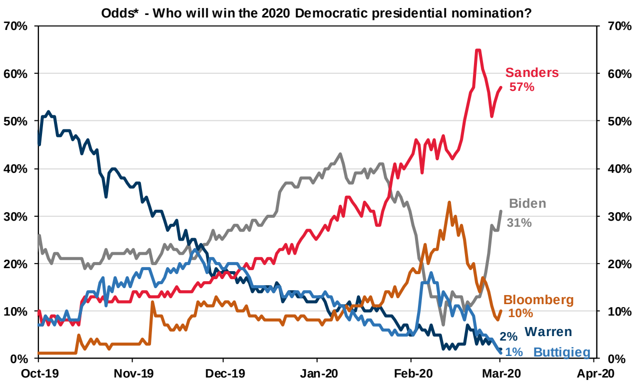
CIO Office (data via WHO). github.com/CSSEGISandData/COVID-19/. As of February 27, 2020.

Therefore, this leaves us in an uncomfortable position where a look in the rear-view mirror shows a series of fundamental reasons for equities to outperform (accommodative monetary policies, strong consumer sentiment and balance sheet, rebounding manufacturing and housing activity, positive economic surprise in emerging markets, etc.), but rapidly rising probabilities of a pandemic – one of the key risks to our economic outlook – blurs nearly all visibility in the near-term.

We should also mention the sharp rise in Bernie Sanders' chances of winning the Democratic nomination (Chart 9, next page) – another key risk on our list – during the month of February. The real test for the self-proclaimed socialist candidate will be *Super Tuesday* on March 3. For now, though, it seems that many assume whatever chances Sanders has of winning the Primary race simply implies better chances that President Trump will be re-elected (Chart 10, next page). But, the growing possibility of a more pronounced slowdown in economic growth could quickly undermine the Republican President's #1 argument and make the race a lot tighter.

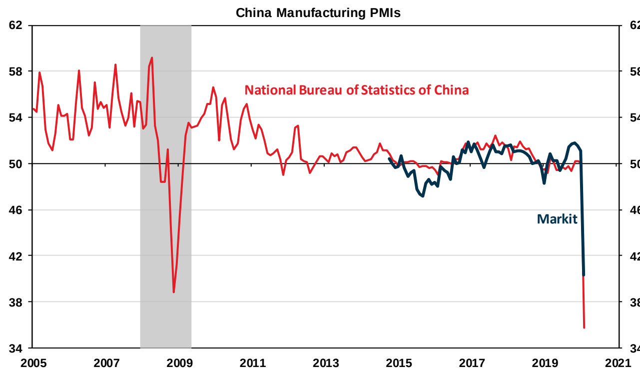
[1] World Health Organization Director General Dr. Ghebreyesus, February 24, 2020.

9 Better chances for Bernie Sanders, ...



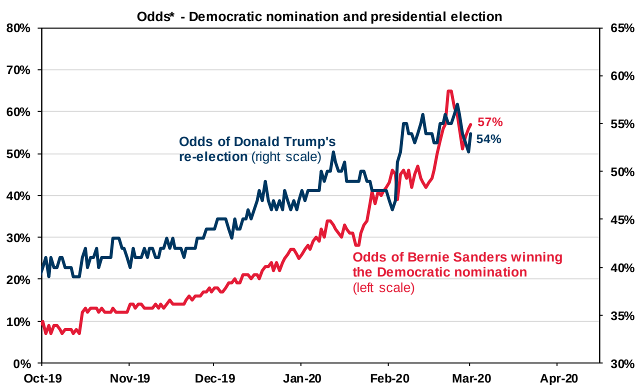
CIO Office (data via *Predictit). As of March 1 2020.

11 Tough month for China's manufacturing sector



CIO Office (data via Refinitiv).

10 **... better chances for Donald Trump?**

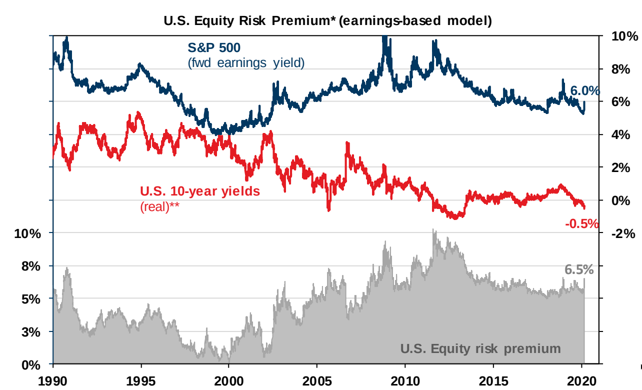


CIO Office (data via *Predicit). As of March 1 2020.

Consequently, we believe that the necessary decision in this context of rapidly rising risks was to move to a more cautious tactical asset mix. We therefore reduced our allocation in equities to neutral on February 26 and increased our positions in fixed income (although we remain underweight) and cash. Over the coming weeks, our main focus will be on the path of contagion, the extent of the containment measures put in place worldwide and the release of the first series of post-Coronavirus economic data. These will undeniably be weak – China's manufacturing PMI collapse just announced is an early example (Chart 11) – and it is highly likely that companies will continue to adjust their forecasts accordingly. The question is, by how much?

To be clear, our shift to a more cautious stance on risk assets is tactical (i.e. short-term horizon), whereas investors should avoid making drastic changes to their strategic (i.e. long-term horizon) asset allocation in the midst of a storm – especially since we continue to view the fundamental economic and monetary backdrop as supportive of equities over a longer investment horizon. The economic impact of a pandemic remains transitory by definition, and we should not underestimate governments and central banks' capacity to rapidly announce stimulative measures should the situation worsen. As such, once the Coronavirus outbreak passes and global growth resumes, equity markets – for which the risk premium remains largely positive in comparison to government bonds (Chart 12) – are likely to experience a sharp recovery on the back of easier monetary and fiscal conditions.

12 The equity risk premium remains largely positive



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 (actual CPI before June 2007).

Equities: Call a Doctor

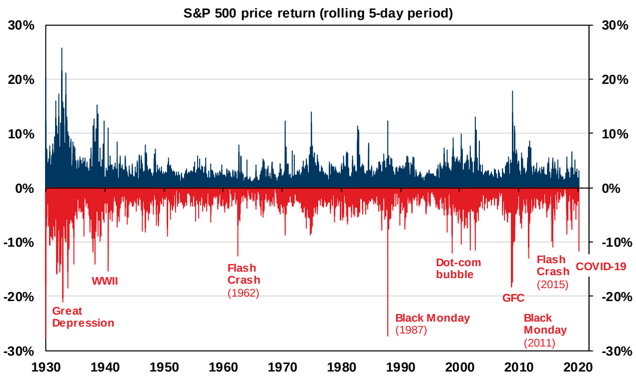
World equities reacted strongly to the risk of a pandemic last month, with U.S. stocks closing February with nothing less than their worst 5-day performance (-11.5%) since August 2011 (Chart 13, next page).

This brings all major equity indices into negative territory year-to-date and close to their levels of early October 2019 (Chart 14, next page).

For now, we continue to expect U.S. equities to fare relatively better than their peers this year. Much uncertainty remains and the S&P 500 is in no way immune from a pandemic-led global slowdown (~43% of its revenues are generated abroad[2]), but the country still compares advantageously to the rest of the world in terms of economic momentum and potential for further

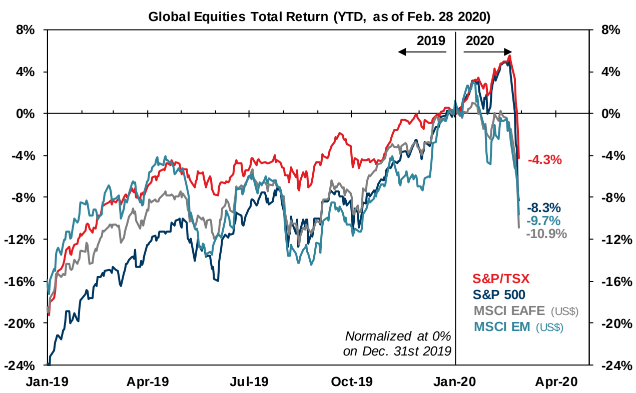
2 NBF Economics and Strategy (data via S&P 500 2018: Global Sales)

13 A sell-off that will go down in history



CIO Office (data via Refinitiv).

14 Return to October 2019 levels for global equities

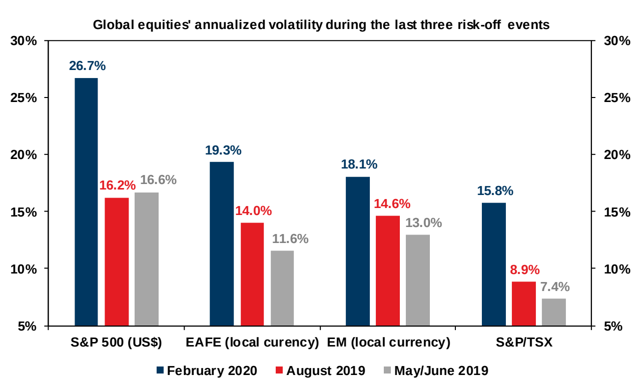


CIO Office (data via Refinitiv).

monetary policy easing. Just like the previous three risk-off events, the speculators' favourite index has been especially volatile compared to its peers in February (Chart 15), but that also entails that the rebound is likely to be sharper.

Turning to Europe, Australasia and the Far East (EAFE) region – where the losses are most acute so far this year – we still hold

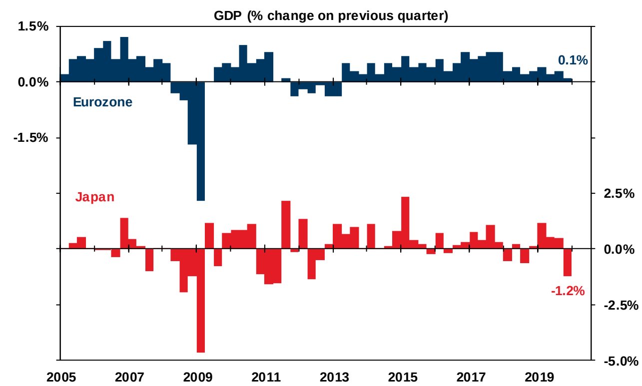
15 S&P 500: still the most turbulent of the family



CIO Office (data via Refinitiv).

to our underweight positioning which we've had for 21 months now. Japan (~25% of the EAFE index) is likely to soon be in a technical recession – defined as two consecutive quarters of GDP contraction – having already shrunk in Q4-2019 following a rise in consumption tax last autumn. As for Europe (~60% of the EAFE index), the latest data still showed positive growth (Chart 16), but its relative economic fragility, dependence on global trade, tourism, and lack of monetary munitions don't bode well in the near-term. If economic disruptions persist, Germany will most certainly consent to deviate from its strict fiscal discipline and boost public spending, but it won't happen overnight.

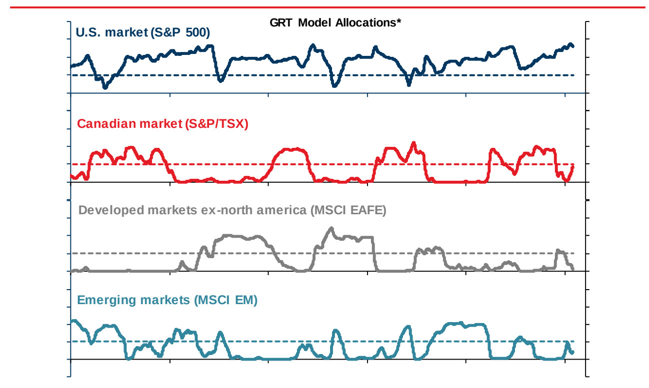
16 Every percentage point counts in Europe and Japan



CIO Office (data via Refinitiv).

The only change we brought to our mix within equities is to reduce emerging markets (EM) back to neutral. Once the Coronavirus outbreak passes, the region is likely to be faced with easier monetary and fiscal conditions, making it a prime candidate to outperform when global growth resumes. However, the timing of such contingency has obviously shifted further away from what we estimated in light of the information available a month ago, while our GRT model recommendation has reverted lower (Chart 17). Thus, a slight reduction in our EM position was warranted, but there will likely be buyers once the dust settles and new data allow for a better assessment of fundamentals.

17 One step backwards for emerging markets

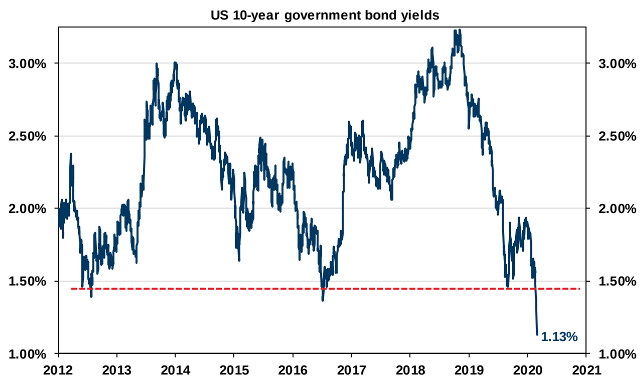


CIO Office (data via Refinitiv). *Equal weight benchmark.

Fixed Income: Central banks on the Call

Demand for safe havens flooded the government bond market late in February, leading the yield on U.S. 10-year Treasury to break down below the lows of 2012 (European debt crisis) and 2016 (China slowdown + Brexit) (Chart 18).

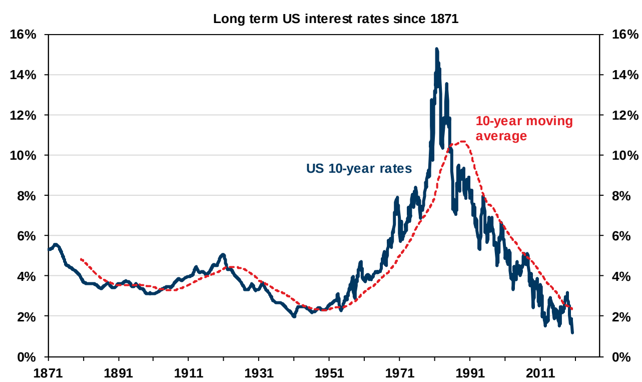
18 U.S. 10-year rates plunged in February...



CIO Office (data via Refinitiv).

At these levels, yields on long-term U.S. public debt stand at nothing less than a 149-year low (according to Shiller data going back to 1871), firmly rooted in a secular downtrend spanning nearly four decades now (Chart 19).

19 ... all the way down to nothing less than a 149-year low



CIO Office (data via Case Shiller).

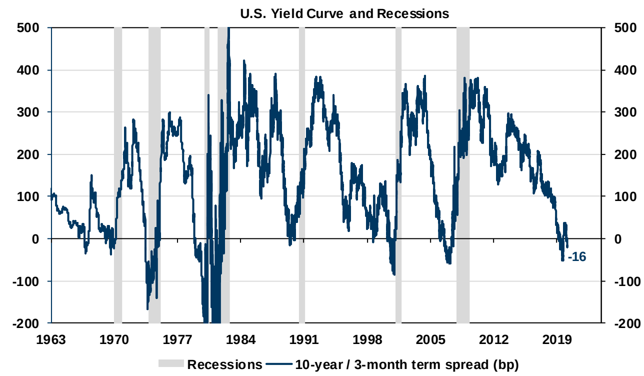
As a result, the yield curve is now back in inversion territory, a signal we continue to view as an imperfect yet compelling call for extra caution (Chart 20).

Similarly, we've seen market-based measures of inflation expectations head lower together with crude oil prices, as investors factored in the inevitability of a slowdown in global growth in the first half of the year (Chart 21).

For their part, credit spreads still haven't reached the levels we've seen during previous significant risk-off events, but they definitely started to widen (Chart 22).

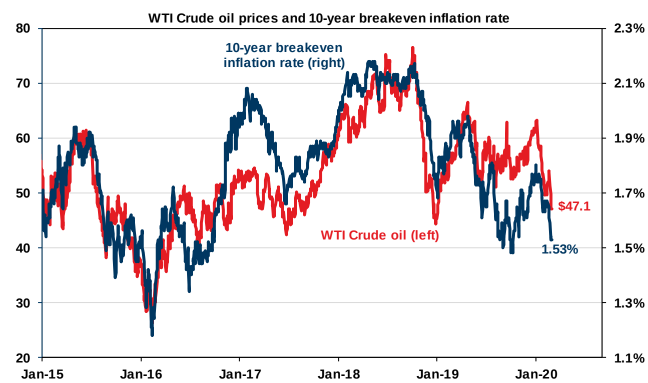
In short, nearly all of the boxes are checked for the Federal Reserve to lower its policy rate at its next meeting on March 18.

20 Yield curve inversion...



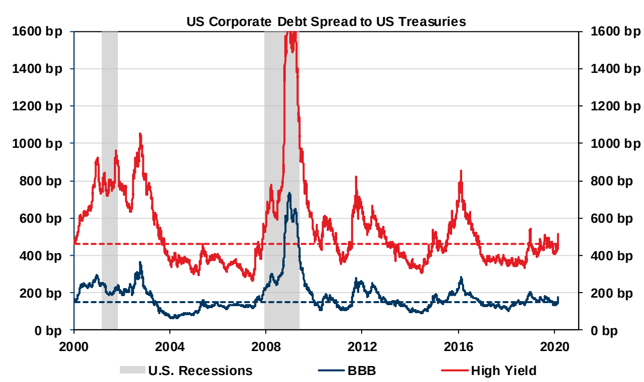
CIO Office (data via Refinitiv).

21 ... sharp drop in market-based measures of inflation[e]...



CIO Office (data via Refinitiv).

22 ... and widening credit spreads: ...

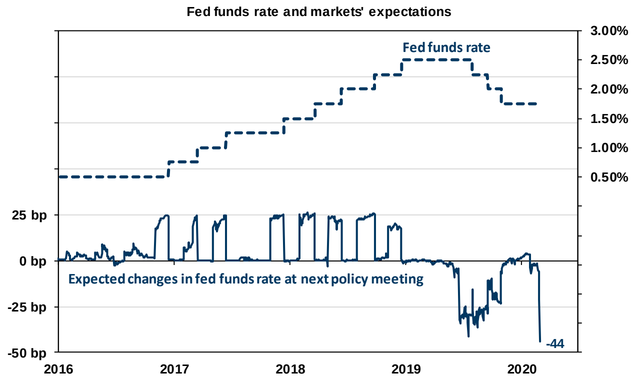


CIO Office (data via Refinitiv).

That is indeed what a February 28 statement issued by the Central Bank suggested when it said that monetary policymakers would "act as appropriate" in response to the "evolving risks" from the Coronavirus. In the eyes of the market, there is no doubt about it. In fact, futures contracts on the Fed funds rate are currently pricing-in a 44-basis point drop in rates

– i.e. a 100% chance of a 25-bp cut, and 76% that it will be the first 50-bp decline since the financial crisis (Chart 23).

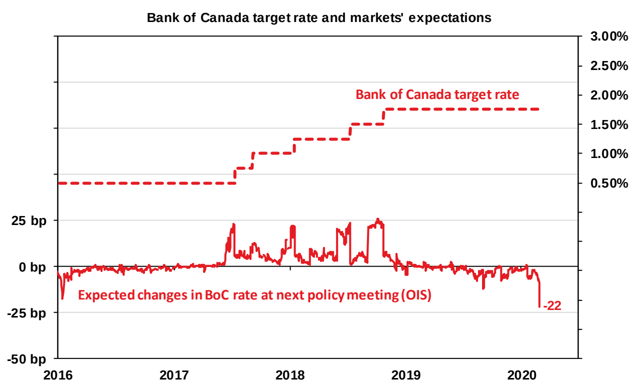
23 ... everything points a rate cut in the United States...



CIO Office (data via Bloomberg).

On our side of the border, the Bank of Canada is also almost certainly going to announce a lower policy rate at its next meeting this Wednesday (March 4). Governor Poloz had already indicated an inclination to ease monetary conditions back in January. The addition of rail blockades and Coronavirus-related economic disruptions only reinforce his case, and the market adjusted accordingly (Chart 24).

24 **... and in Canada**



CIO Office (data via Bloomberg).

Now, what will lower interest rates do to resolve a situation where a virus outbreak leads to quarantines, factory shutdowns, border closures, and travel bans (i.e. supply shocks)? Not much, except to ease pressure on financial markets and ensure sufficient liquidity until the spread of the disease runs its course. But, once things get back to normal, easier monetary conditions (which were thankfully already accommodative) should support a quick recovery in economic activity.

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General

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