Asset Allocation Strategy

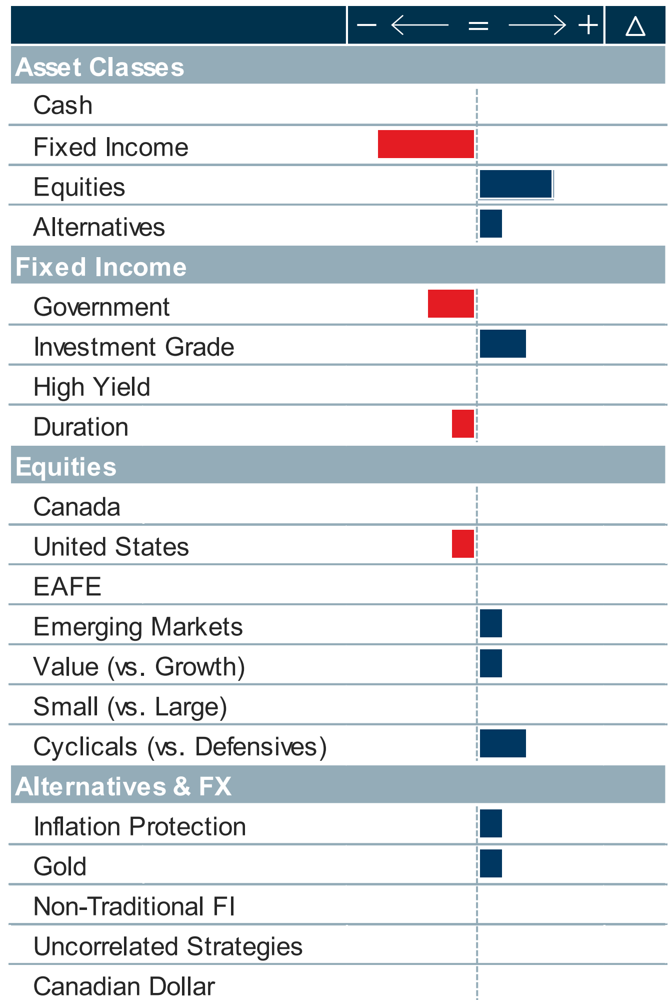
CIO Office | July 2021

Time to talk

Highlights

- Equity markets closed the first half of the year on a rather positive note, outperforming their bond counterparts for the fifth consecutive quarter. However, what stood out in Q2 was the broad-based nature of gains across market segments against a background of slightly lower interest rates. A sharp contrast to the first three months of 2021.
- How can we reconcile this drop in yields with the spectacular rise in inflation? Aside from the fact that the jump in rates in Q1 called for a pause on a technical basis, a key explanatory factor is that we may have seen the peak in year-over-year inflation figures, at least in the short term.
- Fed Chairman Jerome Powell in referring to the June FOMC meeting as the "talking about talking about meeting" and presenting a median projection of two rate hikes in 2023 constitutes a first step toward scaling back monetary accommodation. The second step should be to clarify the plan for a gradual reduction in their asset purchases, conditional on a sustained improvement in the labour market – the key variable to monitor in the quarters that lie ahead.
- There is little doubt that we stand at the peak of the pace of growth on an annual basis. But despite their slowdown, corporate profits should continue to drive stock markets higher as the overall backdrop remains pro-risk.
- Geographically, we continue to advocate diversification over aggressive positioning as performance differentials between equity regions have been highly volatile and relatively limited in magnitude since the start of the pandemic. Emerging markets are facing risks, but their valuations suggest that many are already discounted.

Table 1 Global Asset Allocation Views



This table is for illustration purposes only. Bars represent the degree of preference of an asset relative to the maximum deviation allowed from a reference index. The further to the right (left) they are, the more bullish (bearish) our outlook for the asset is. 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.

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Market Review

- Despite a sharp rise in inflation, 10-year benchmark yields, although quite volatile following the latest FOMC meeting, had slipped lower by month's end.
- Similar movements in Canada helped longer maturity bonds outperform their lower duration counterparts this past month.
- Meanwhile, U.S. Investment Grade and High-Yield Credit benefitted from an ever-shrinking credit spread.

Equities

- The first half of the year closed out with developed market equities reaching new record heights, thanks in large part to the successful vaccination drive and the progressive reopening of most of the group's economies.
- Technology companies fared particularly well in June as well as in the second quarter, supported in part by lower interest rates.
- Emerging market equities lagged in the first half of the year, but still recorded considerable gains over the period.

FX & Commodities

- Energy prices further strengthened in June, with the WTI Index climbing another 11% to $73 per barrel, a level not seen since October 2018.
- Meanwhile, the Greenback and Gold moved in opposite directions last month, with the former spurting up following the latest FOMC meeting.

Table 2 **Market Total Returns**

Asset Classes	June	Q2	YTD
Cash (3-month T-bills)	0.0%	0.0%	0.1%
Bonds (FTSE CA Univ.)	**1.0%**	**1.7%**	**-3.5%**
FTSE CA Short term	-0.2%	0.1%	-0.5%
FTSE CA Mid term	0.5%	1.6%	-3.0%
FTSE CA Long term	2.8%	3.7%	-7.4%
FTSE CA Government	1.0%	1.8%	-3.9%
FTSE CA Corporate	0.8%	1.3%	-2.3%
BoAML Inv. Grade ($US)	1.7%	3.6%	-1.1%
BoAML High-Yield ($US)	1.4%	2.8%	3.7%
Preferred Shares	-0.2%	5.0%	14.3%
CA Equities (S&P/TSX)	**2.5%**	**8.5%**	**17.3%**
Energy	6.4%	13.9%	37.0%
Industrials	0.3%	0.2%	6.8%
Financials	0.7%	8.3%	23.4%
Materials	-6.2%	6.9%	-0.4%
Utilities	2.3%	1.4%	4.9%
Cons. Disc	0.1%	4.6%	17.6%
Cons. Staples	1.4%	5.8%	8.5%
Healthcare	0.9%	-11.6%	22.0%
IT	18.2%	23.0%	21.7%
Comm. Svc.	3.8%	10.4%	18.2%
REITs	4.2%	10.7%	21.7%
S&P/TSX Small Cap	0.5%	9.2%	19.8%
US Equities (S&P500 USD)	**2.3%**	**8.5%**	**15.3%**
Energy	4.6%	11.3%	45.6%
Industrials	-2.2%	4.5%	16.4%
Financials	-3.0%	8.4%	25.7%
Materials	-5.3%	5.0%	14.5%
Utilities	-2.2%	-0.4%	2.4%
Cons. Disc	3.8%	6.9%	10.3%
Cons. Staples	-0.2%	3.8%	5.0%
Healthcare	2.3%	8.4%	11.9%
IT	7.0%	11.6%	13.8%
Comm. Svc.	2.7%	10.7%	19.7%
REITs	3.2%	13.1%	23.3%
Russell 2000 (USD)	1.8%	4.1%	17.0%
World Eq. (MSCI ACWI)	**1.4%**	**7.5%**	**12.6%**
MSCI EAFE (USD)	-1.1%	5.4%	9.2%
MSCI EM (USD)	0.2%	5.1%	7.6%
Commodities (CRB index)	**3.7%**	**15.4%**	**27.2%**
WTI Oil (US$/barrel)	11.0%	24.4%	52.5%
Gold (US$/ounce)	-7.4%	3.6%	-7.0%
Copper (US$/tonne)	-8.8%	6.4%	20.7%
Forex (DXY - USD index)	**2.7%**	**-0.8%**	**2.8%**
USD per EUR	-3.0%	0.9%	-3.1%
CAD per USD	2.8%	-1.3%	-2.7%

Data via Refinitiv 2021-06-30

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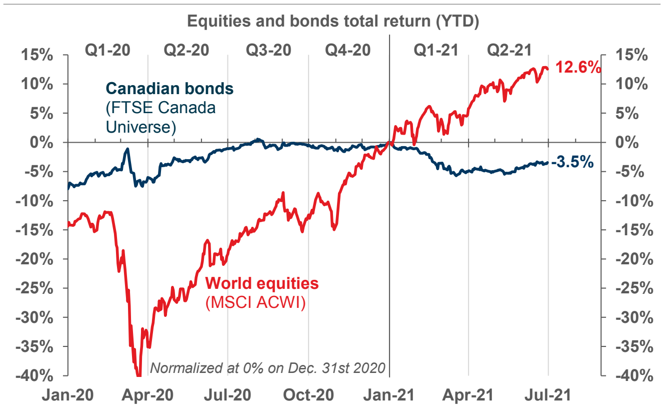
Inflation up, rates down?

Equity markets closed the first half of the year on a rather positive note, outperforming their bond counterparts for the fifth consecutive quarter (**Chart 1**).

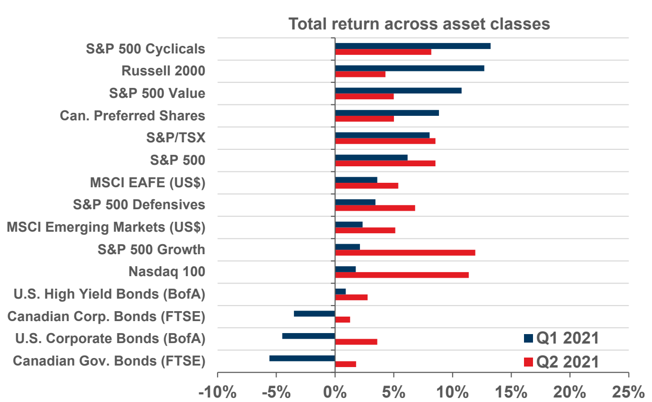
1 | Equities remain on their uptrend…



CIO Office (data via Refinitiv).

However, what stands out in Q2 is the broad-based nature of the gains between bond and various segments of the equity market, together with the outperformance of the growth style south of the border. A sharp contrast to the first three months of 2021 (**Chart 2**).

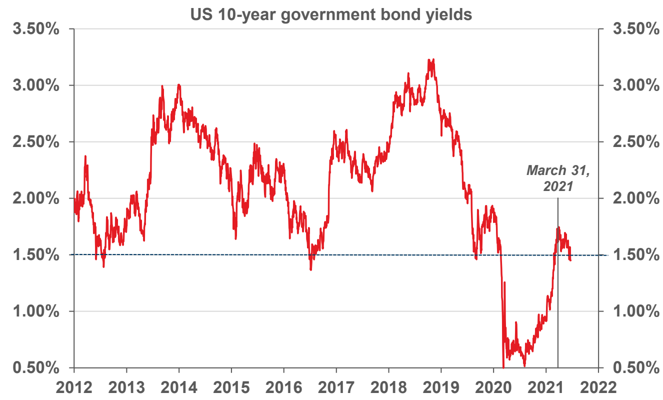
2 | … but there are some contrasts with Q1…



CIO Office (data via Refinitiv).

This market picture largely reflects the decline in interest rates observed since the end of March, with 10-year U.S. Bond yields closing the month of June just below 1.5% (compared to 1.74% on March 31, **Chart 3**).

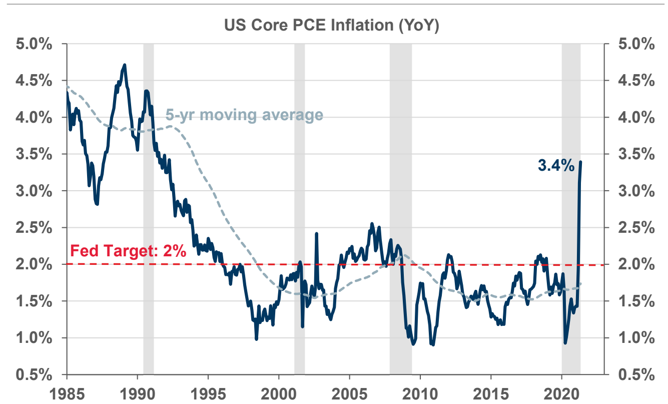
3 | … owing to a slight drop in Treasury yields…



CIO Office (data via Refinitiv).

How can we reconcile this drop in yields with the spectacular rise in year-on-year inflation (no less than a record high since 1992, **Chart 4**) over the period?

4 | … that may seem counter-intuitive



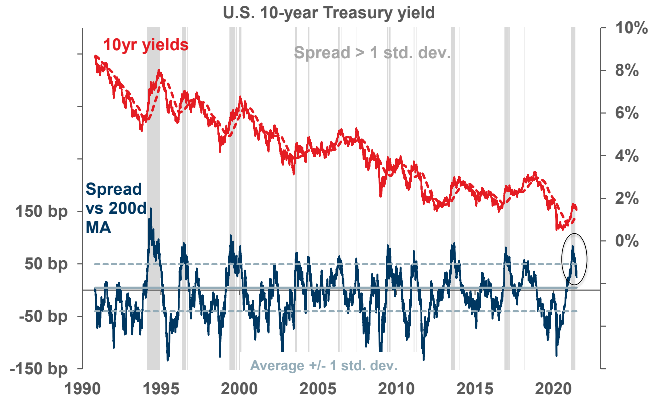
CIO Office (data via Refinitiv).

Aside from the fact that the jump in rates at the beginning of the year signaled (at the very least) a pause on a technical basis as we argued in our April report (**Chart 5**, next page), a key explanatory factor is that we may have seen the peak in year-over-year inflation figures, at least in the short term.

Indeed, the simple arithmetic nature (i.e. base effects) of annual inflation figures should lead to stabilization or even a sharp decline over the next few months, though there is still potential for a sharp rise late 2021/early 2022 (**Chart 6**).

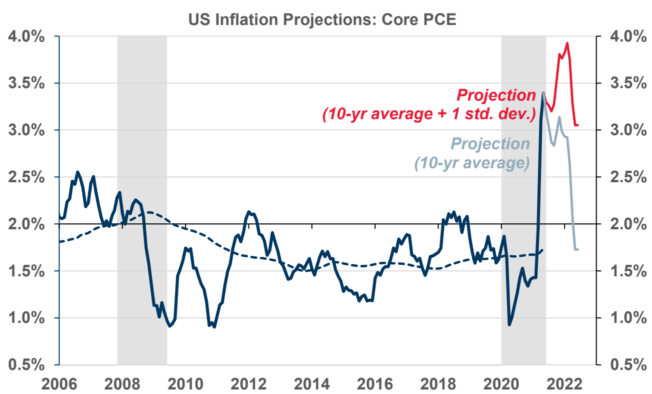
It's difficult to foresee exactly to what extent the strength in underlying inflation (beyond base

5 | Treasury yields were due for a technical break



CIO Office (data via Refinitiv).

6 | The biggest base effects are now behind…

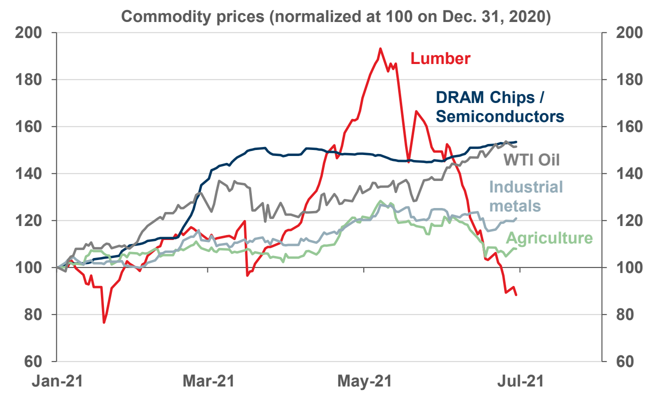


CIO Office (data via Refinitiv).

effects) observed in recent months will persist. While we can still reasonably expect upward pressure resulting from post-pandemic supply bottlenecks, it is worth noting that, with the exception of oil, prices of several commodities acting as input into the production of goods have stabilized (semiconductors) or even fallen (industrial metals, agriculture, lumber) in recent weeks (**Chart 7**). These are not the sort of price movements consistent with runaway inflation.

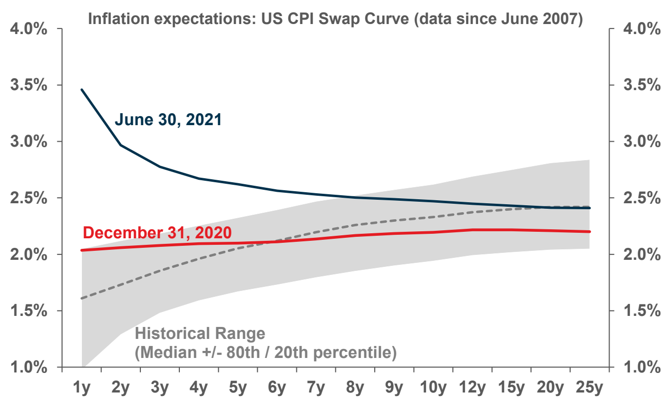
In any case, it is worth recalling that markets are forward-looking; they have already adjusted their expectations to reflect a period of substantially higher inflation in the short term, followed by a convergence toward a level that is certainly higher than in recent years, but not necessarily of concern (**Chart 8**).

7 | ... and several input prices have stabilized



CIO Office (data via Refinitiv). DRAM = Dram exchange index (DXI). Industrial metals = GSCI Index (alluminum, copper, zinc, nickel, lead). Agriculture = GSCI Index (Coffee, Sugar, ,Cocoa, Cotton).

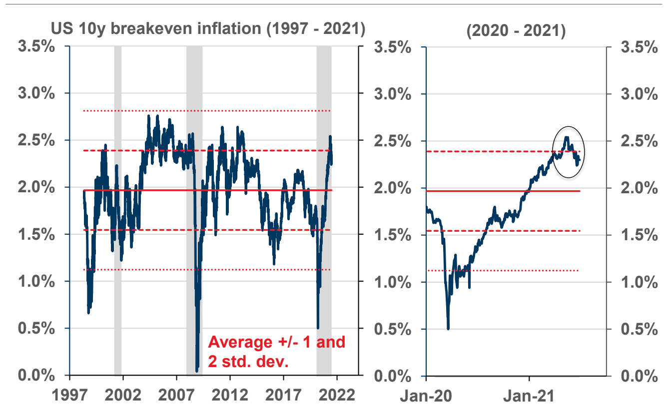
8 | High inflation: markets' base-case scenario...



CIO Office (data via Refinitiv).

Could it be that this outlook overstates the true nature of upcoming inflation? This would not be the first time, and it is indeed this questioning that we are witnessing in the bond markets (**Chart 9**)... especially now that the Federal Reserve has started to more openly discuss the eventual normalization of its monetary policy.

9 | ... slightly called into question lately



CIO Office (data via Refinitiv).

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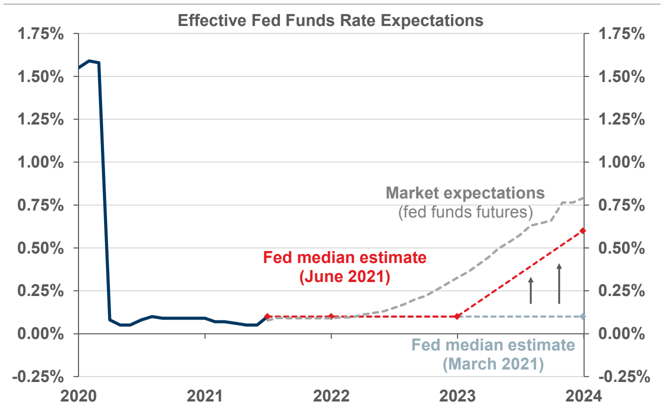
Time to talk

After repeatedly telling us that he was "not even thinking about thinking" about raising interest rates, Fed Chairman Jerome Powell opted for a new catchphrase at the end of the last FOMC meeting by saying that this meeting could be considered as the "talking about talking about meeting."

What does this all mean? Simply put, the institution is acknowledging the fact that the economic and health situations are turning out to be much more positive than their (deliberately more conservative) scenarios originally projected. As a result, the median projection of the FOMC members now indicates two interest rate hikes in 2023 (vs. none previously), not far from what is discounted by Fed funds futures (**Chart 10**).

10 | Higher policy rate projections at the Fed...

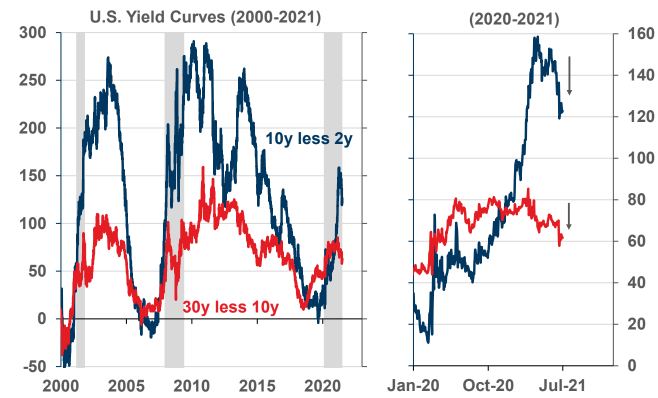


CIO Office (data via Refinitiv, Bloomberg). As of June 29, 2021.

On the bond markets, this adjustment in the Fed's message has resulted in a marked flattening of the yield curve (**Chart 11**). Loosely translated, the nearer outlook for rate hikes (higher 2-year yields) limits the risk that the Fed will be caught in catch-up mode in the face of steep inflation later in the decade (lower 30-year yields).

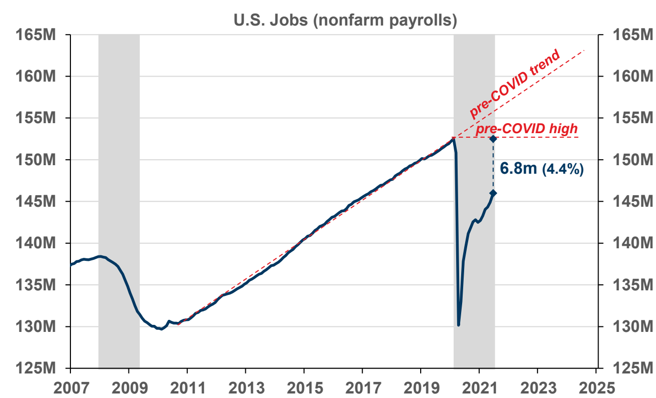
Let's keep in mind that these rate hike projections are still far in the future and highly uncertain. The determining factor as to when they will materialize is unequivocally the state of the labour market. With more than 7 million jobs below pre-pandemic levels, there is still a long way to go before the Fed walks the talk on raising rates (**Chart 12**).

11 | … lower long-term rates on the bond market…



CIO Office (data via Refinitiv).

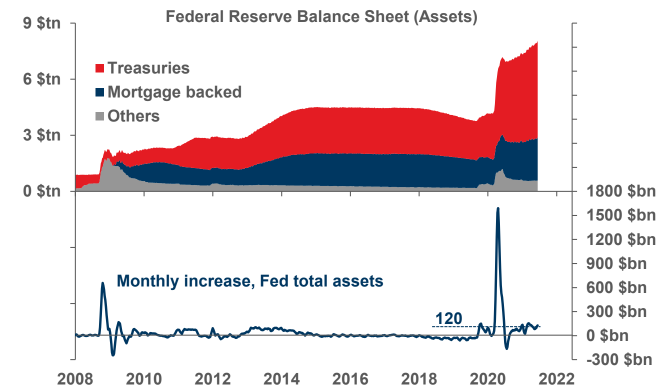
12 | ... but still a long way to go for the labour market



CIO Office (data via Refinitiv).

That said, the first step towards scaling back monetary accommodation was to talk about it, and this is now done. The second step should be to clarify the plan for a gradual reduction in their asset purchases, which currently stand at around 120 billion per month (**Chart 13**, next page). Stay tuned… probably at the end of August (at the Jackson Hole conference concluding on August 26) or the end of September (next update of the Fed's projections, on September 22).

13 | Next step: reducing asset purchases

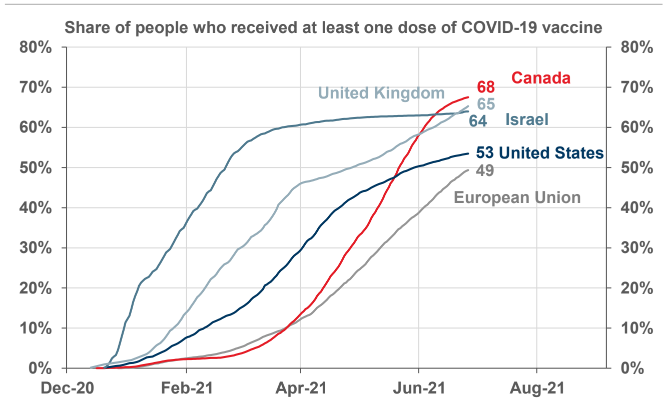


CIO Office (data via Refinitiv).

The bottom line

As we enter a new quarter, we have updated our base-case economic scenario, which remains pro-risk (see Table 3 in the Appendix for more details). On the health front, high vaccine coverage (particularly in Canada, which after a slower start is now leading the world, right on time for its national day, **Chart 14**) and the low level of contagion (new cases and deaths are at the lowest point since the start of the pandemic, **Chart 15**) effectively relegates COVID to second-string status for markets, until proven otherwise.

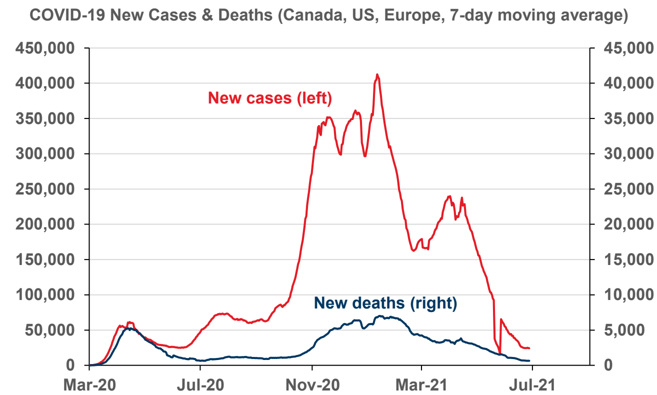
14 | *O Canada, vaccines stand on guard for thee*



CIO Office (data via Our World in Data).

This emergence from the crisis also implies that the vast majority of generous government income support programmes will be phased out by the end of September. We view this as a positive development as it should encourage a return to

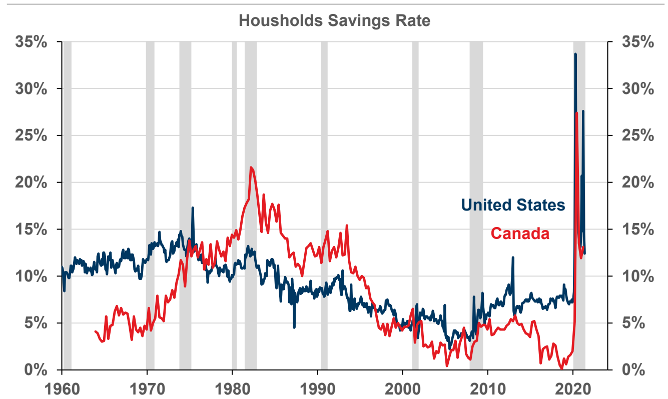
15 | COVID-19: new cases and deaths at a low point



CIO Office (data via Johns Hokpins University).

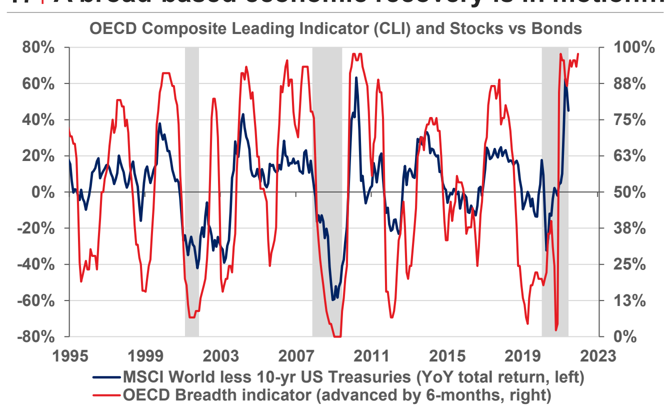
work, while the accumulated excess savings (**Chart 16**) and the strong economic momentum already seen in the vast majority of countries (**Chart 17**) demonstrate a recovery on a solid footing.

16 | Strengthened household balance sheets



CIO Office (data via Refinitiv).

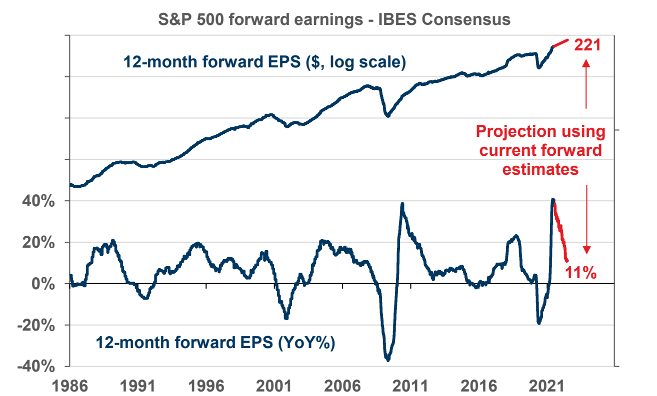
17 | A broad-based economic recovery is in motion…



CIO Office (data via Refinitiv).

Nevertheless, there is little doubt that we stand at the peak of the pace of economic growth on a year-over-year basis. After reaching a record high since the data has been compiled (1986), expected earnings growth for the S&P 500 is set to slow as we move away from the trough caused by the pandemic (**Chart 18**).

18 | ... although its speed is bound to slow down…



CIO Office (data via Refinitiv).

This arithmetic phenomenon is hardly surprising post-recession; we experienced something similar as we emerged from the financial crisis. Historically, the 12 months following a peak in growth have generally resulted in stock market gains, albeit smaller ones, on average (**Chart 19**). This is indeed a reasonable expectation moving forward.

19 | … much like the stock market…

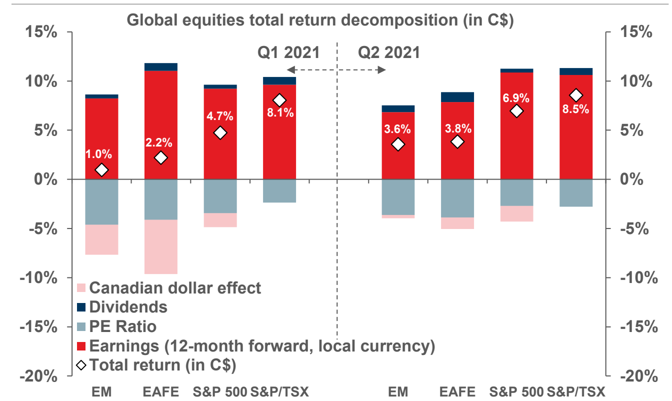
S&P 500 total return around a peak in earnings growth

Month of peak growth	Total return	
	12 months before peak	12 months after peak
February 1989	11.9%	18.9%
June 1995	26.1%	26.0%
August 1997	40.6%	8.1%
June 2000	7.2%	-14.8%
July 2004	13.2%	14.1%
May 2010	21.0%	25.9%
September 2014	19.7%	-0.6%
September 2018	17.9%	4.3%
June 2021	39.8%	?
Average	**21.9%**	**10.2%**

CIO Office (data via Refinitiv).

Indeed, despite its slowdown, earnings growth over the next year (the consensus is for an 11% increase) should continue to be the main driver of stock market returns, as it has been in the first two quarters of 2021 (**Chart 20**).

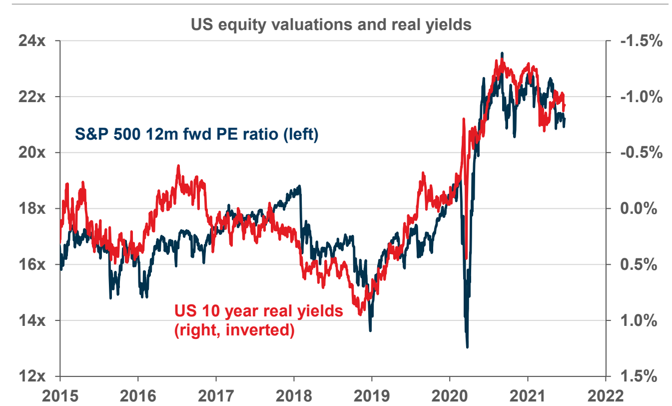
20 | ... which should continue to be driven by earnings



CIO Office (data via Refinitiv).

To what extent valuations will have to adjust depends largely on the evolution of the key risk to our economic scenario, i.e. the direction of inflation and, more importantly, the reaction of the Federal Reserve. As long as underlying inflation is neither too high nor too low, the Fed can afford to remain highly cautious and patient in its monetary policy normalization process. If this is the case, real interest rates should remain in negative territory, thus avoiding downward pressure on multiples (**Chart 21**).

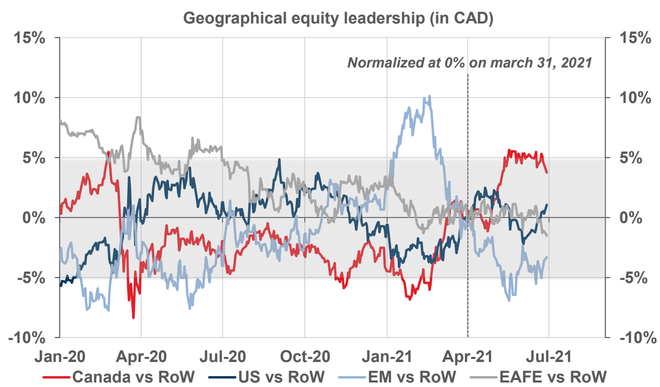
21 | Equity valuations depend on real yields



CIO Office (data via Refinitiv).

In terms of geographic leadership within equity markets, we continue to advocate diversification over aggressive positioning. While the past quarter has proven advantageous for Canadian equities (which we upgraded from Underweight to Neutral on April 1) and more challenging for emerging markets (which we reduced on April 1, although we remained overweight), the reality is that performance differentials between regions have been highly volatile and relatively limited in magnitude (mostly within +/- 5%) since the start of the pandemic (**Chart 22**). Such an environment can be costly for those trying to capture every one of these hardly predictable swings.

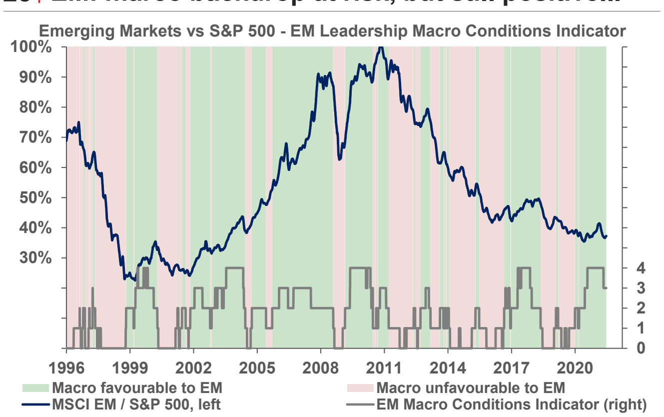
22 | Cross-currents between equity regions



CIO Office (data via Refinitiv). RoW = Rest of the Wolrd = average of the three other regions.

For now, we are maintaining our slight overweight in emerging markets against U.S. equities, as recommended by our model to that effect (**Chart 23**). The main risk associated with this positioning resides in a sharp rebound in the U.S. dollar that could be caused by premature tightening of monetary conditions in the U.S., as well as in China, where credit growth has already slowed significantly. However, the valuation gap between the two regions suggests that many of these risks

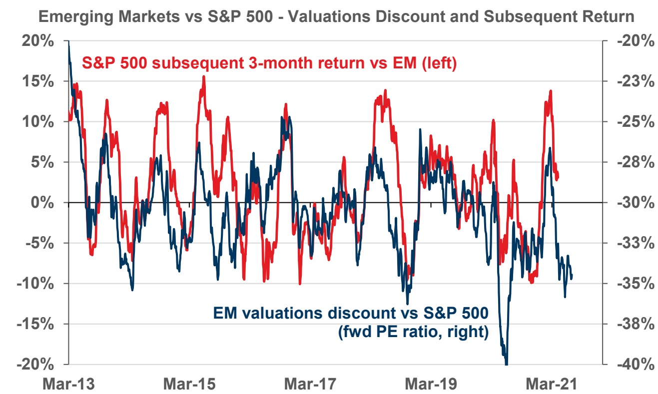
23 | EM: marco backdrop at risk, but still positive...



CIO Office (data via Refinitiv). The indicator measures 4 conditions: (1) USD on a downtrend, (2) broad-based global growth, (3) large majority of central banks accommodative, (4) EM positive relative momentum.

are already discounted, while a more favourable turn of events could quickly unlock gains (**Chart 24**).

24 | ... and a valuation gap to their advantage



CIO Office (data via Refinitiv).

In terms of sector/factor leadership, we continue to see greater potential for stocks with cyclical characteristics. This view is largely dependent on the direction of interest rates, for which upside potential seems higher than the downside (**Chart 25**).

25 | Rates hold the key to style & sector leadership

CIO Office (data via Refinitiv). *Cyclicals/Value = Financials, Materials, Energy, Industrials, Real Estate, Cons. Discr.. Defensive/Growth = Utilities, Cons. Staples, Health Care, Technology, Telecom.

That said, our call for diversification also applies here given the uncertainty over the path of interest rates and inflation. We may therefore quickly look to increase our exposure to higher growth stocks if an opportunity arises over the coming months.

Table 3 Base Case Scenario

Scenario (prob.*)	Key elements and investment implications
Base case 70%	With the success of vaccination campaigns, COVID-19 essentially becomes a secondary issue in early summer in the United States, and shortly after in other developed countries. The number of new cases remains relatively low, but more importantly, pressure on the health system and mortality rates drop significantly.
	The pace of global growth peaks in early summer. Nevertheless, strong underlying trends such as a substantial accumulation of excess savings, rising consumer sentiment and a strong recovery in the services sector keep growth above its long-term average.
	The majority of developed countries policy makers are initiating a gradual and cautious phase-out of emergency fiscal support. In the U.S., the Biden administration works for the passage of a major infrastructure plan and moderate tax increases, not too distant from his campaign pledges.
	Annual inflation rises considerably, driven by a combination of base effects, strong demand and supply bottlenecks. Concerns of economic overheating and potential rate hikes grow occasionally, but central banks stay the course and keep accommodative monetary measures unchanged through the year. The Fed clarifies its intentions regarding the gradual reduction of its asset purchases between August and September 2021.
	→ **Bond yields rise modestly while global equities continue to rise along their long-term trend. Leadership remains volatile but edge in favour of cyclical and emerging markets equities.**
Bullish 20%	The high efficacy of the vaccines allows a definitive victory against COVID-19 and its variants. The reopening of economies reveals an unsuspected pent-up demand. Consumer sentiment surges; excess savings accumulated during the pandemic translate into consumer spending.
	After rising sharply, inflation stabilises to settle slightly above historical averages as supply adjusts. This goldilocks backdrop of strong real growth and moderate inflationary pressures proves highly favourable for risky assets as rate hikes remain distant.
	→ **Bond yields tread water while the U.S. dollar depreciates. Global equities surge above their long-term trend. Leadership remains volatile. Emerging markets equities outperform significantly.**
Bearish 10%	Strong inflationary pressures push long-term inflation expectations into a range that forces central banks to tighten monetary conditions earlier than expected. In parallel, uncertainty over U.S. fiscal policy, Big Tech regulations and/or Democrats protectionist intentions force markets to recalibrate their expectations.
	Vaccination campaigns fail to counter the rapid spread of coronavirus variants in some parts of the world. Fears of another wave of contagion as autumn arrives negatively impact consumer sentiment, global growth slows.
	→ **Bond yields volatility increases and the U.S. dollar shoots higher. Equities venture in correction territory. Leadership is highly volatile but edges in favour of growth (value) stocks in the COVID revival (inflationary pressure) scenario.**

CIO Office. Last update: July 2, 2021 (updated quarterly unless an event demands a revision). *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 pro-risk.
Fixed Income	40%	-	31.0%	-9.0%	-	-	
Equities	60%	-	64.0%	4.0%	-	-	
Alternatives	0%	-	5.0%	5.0%	-	-	
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 rise modestly as inflation expectations normalise, but we expect real yields to remain negative.
Investment Grade	12%	27%	14.5%	2.5%	45%	18.3%	
High Yield	0%	0%	0.0%	0.0%	0%	0.0%	
Duration	*7.8 yrs*	-	*7.5 yrs*	-0.3 yrs	-	-	
Equities							
Canada	21%	35%	22.4%	1.4%	35%	0.0%	We expect emerging markets to outperform U.S. equities under a backdrop of broad-based global growth and easy monetary policies, with a preference for cyclical and value sectors in EM (RAFI Fundamental, 3%). In the U.S, we favour the high-quality (MSCI Quality, 4% weight) dividend-paying (Div. Aristocrats, 4%) companies and the equal weight index (4%) for their diversified and cyclical properties.
United States	21%	35%	21.0%	0.0%	33%	-2.2%	
EAFE	12%	20%	12.8%	0.8%	20%	0.0%	
Emerging markets	6%	10%	7.8%	1.8%	12%	2.2%	
Alternatives							
Inflation Protection	0%	0%	2.0%	2.0%	40%	40.0%	The macroeconomic environment remains favourable to gold, with real interest rates likely to remain negative 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%	3.0%	3.0%	60%	60.0%	
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%	-	55.4%	-5.6%	-	-	Our overall portfolio strategy places us overweight in U.S. dollars versus our benchmark, solely through our gold position. Although our base case scenario is consistent with a slight appreciation of the Canadian dollar, we maintain this positioning solely for risk management purposes as gold in CAD offers more attractive historical properties from a portfolio construction standpoint.
U.S. Dollar	21%	-	24.0%	3.0%	-	-	
Euro	5%	-	4.9%	0.3%	-	-	
Japanese Yen	3%	-	3.3%	0.2%	-	-	
British Pound	2%	-	1.8%	0.1%	-	-	
Others	9%	-	10.7%	2.0%	-	-	

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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