Asset Allocation Strategy

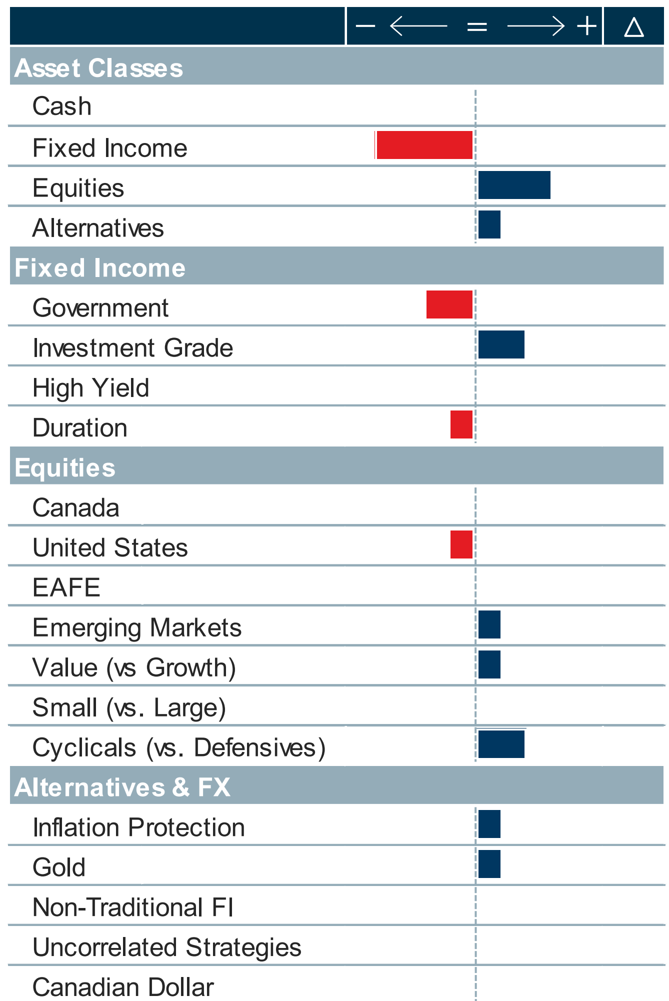
CIO Office | May 2021

A Hot Summer Ahead

Highlights

- Market conditions proved to be rather clement for risky assets in April, with global equities remaining firmly engaged in their uptrend and Treasury yields taking a breather.
- Is the mild Spring a harbinger of a hot Summer for the economy? It appears so. The sizeable excess savings accumulated since the onset of the pandemic highlight the potential for a strong pick-up in aggregate demand in the quarters ahead, provided that consumer confidence is high enough. Judging by the latest readings on this matter, it looks like it will be the case.
- The looming economic heat this Summer could prove uncomfortable at times, should markets have doubts about the transitory nature of the inevitable spike in inflation. Besides, our sentiment indicator is nearing extreme optimism, which implies that any bit of bad news could trigger volatility in the short term.
- Nevertheless, the acceleration in the vaccination campaign together with a powerful mix of accommodative monetary and fiscal policies remain supportive of risk assets' outperformance. Investors must temper their return expectations, but corporate earnings growth should be more than enough to allow stocks to outperform bonds over the next 12 months.
- Against this background, we are keeping our asset allocation unchanged and continue to watch for opportunities to increase our equity overweight.

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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NATIONAL BANK INVESTMENTS

Market Review

Fixed Income

- Government bond returns were flat in April, as interest rates treaded water throughout the month in a break from the recent upward trend.
- Further up the risk ladder, U.S. credit performed marginally better, although spreads remain nearly unchanged from a month ago as well.

Equities

- The latest earnings season for Canadian and U.S. companies kicked off in April, with both countries' major indexes having so far posted strong year-over-year growth.
- In point of fact, every sector within the S&P 500 gained over the last month, helping it close out the month as the top performing major region.
- Meanwhile, implied volatility reached a pandemic low, helped in large part by the global vaccine rollout.

FX & Commodities

- The WTI climbed close to 10% in April, buoyed in part by the International Energy Agency's higher oil demand forecasts. Of note, the Index celebrated its one-year anniversary of its historical and infamous dip into negative price territory.
- The value of gold also strengthened last month, partially reversing its year-to-date losses and climbing above its 50-day moving average for the first time since early January.
- Meanwhile, the U.S. dollar weakened against a basket of six trading partners.

Table 2 Market Total Returns

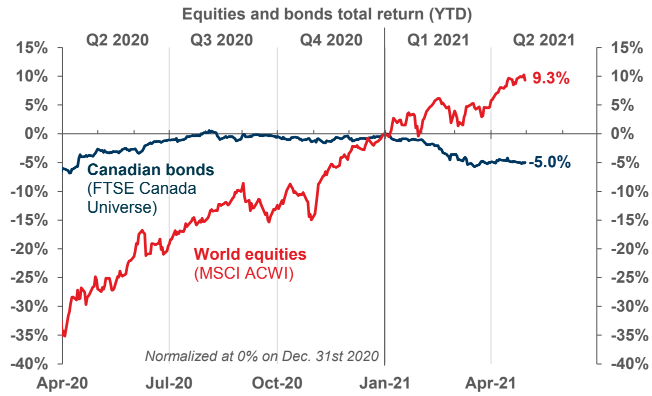
Asset Classes	April	YTD	12 MTH
Cash (3-month T-bills)	0.0%	0.0%	0.2%
Bonds (FTSE CA Univ.)	**0.1%**	**-5.0%**	**-2.0%**
FTSE CA Short term	0.2%	-0.4%	1.6%
FTSE CA Mid term	0.5%	-4.0%	-1.0%
FTSE CA Long term	-0.5%	-11.1%	-7.3%
FTSE CA Government	0.1%	-5.5%	-3.7%
FTSE CA Corporate	0.0%	-3.5%	2.7%
BoAML Inv. Grade ($US)	1.2%	-3.4%	5.1%
BoAML High-Yield ($US)	1.1%	2.0%	20.1%
Preferred Shares	2.1%	11.1%	35.6%
CA Equities (S&P/TSX)	**2.4%**	**10.6%**	**33.3%**
Energy	2.5%	23.3%	27.7%
Industrials	-1.8%	4.7%	32.3%
Financials	3.0%	17.3%	48.5%
Materials	5.5%	-1.7%	10.3%
Utilities	-0.5%	3.0%	20.6%
Cons. Disc	5.1%	18.2%	71.3%
Cons. Staples	0.0%	2.6%	10.1%
Healthcare	-9.2%	25.2%	42.4%
IT	3.8%	2.7%	49.1%
Comm. Svc.	3.0%	10.3%	15.9%
REITs	4.4%	14.8%	35.6%
S&P/TSX Small Cap	4.2%	14.3%	66.6%
US Equities (S&P500 USD)	**5.3%**	**11.8%**	**46.0%**
Energy	0.6%	31.6%	35.8%
Industrials	3.6%	15.4%	61.6%
Financials	6.6%	23.6%	62.9%
Materials	5.3%	14.9%	62.9%
Utilities	4.3%	7.2%	20.6%
Cons. Disc	7.1%	10.4%	51.3%
Cons. Staples	2.2%	3.4%	22.8%
Healthcare	4.0%	7.3%	23.7%
IT	5.3%	7.3%	54.1%
Comm. Svc.	7.9%	16.6%	52.4%
REITs	8.3%	18.1%	30.6%
Russell 2000 (USD)	2.1%	14.8%	72.9%
World Eq. (MSCI ACWI)	**4.4%**	**9.3%**	**46.4%**
MSCI EAFE (USD)	3.1%	6.8%	40.5%
MSCI EM (USD)	2.5%	4.9%	49.2%
Commodities (CRB index)	**8.0%**	**19.1%**	**70.6%**
WTI Oil (US$/barrel)	9.9%	34.7%	245.1%
Gold (US$/ounce)	3.9%	-6.7%	3.9%
Copper (US$/tonne)	11.8%	26.8%	90.5%
Forex (DXY - USD index)	**-2.1%**	**1.5%**	**-7.8%**
USD per EUR	2.4%	-1.6%	9.9%
CAD per USD	-2.1%	-3.5%	-11.9%

Data via Refinitiv 2021-04-30

A mild Spring…

Market conditions proved rather clement for risky assets in April, with global equities remaining firmly engaged in their uptrend and bonds treading water (Chart 1).

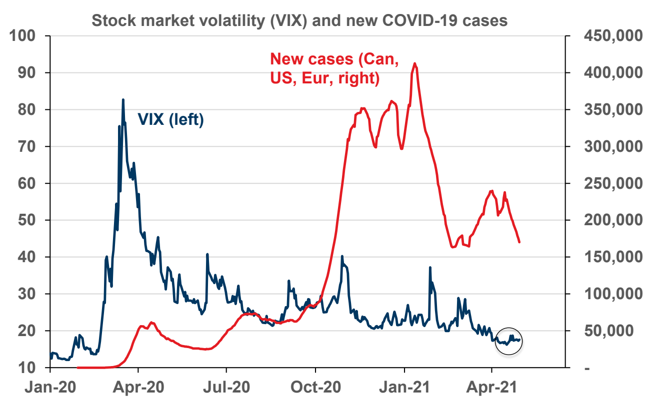
1. Equities remain engaged in their uptrend…



CIO Office (data via Refinitiv).

The stock market fear index (VIX) has even reached its lowest point since the beginning of the pandemic (Chart 2), reflecting both the acceleration of global vaccine rollouts (Chart 3) and the growing evidence of their effectiveness.[1]

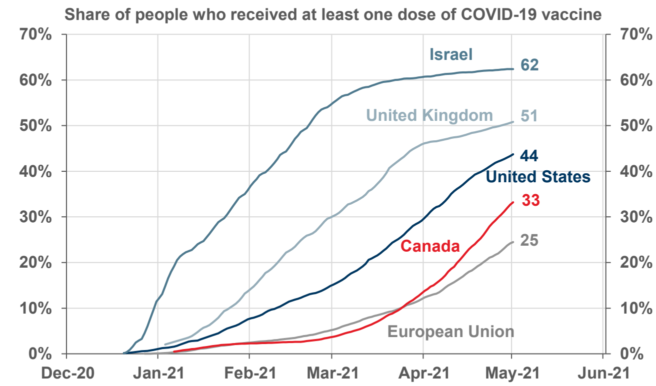
2. ... with volatility at a pandemic low...



CIO Office (data via Refinitiv, Johns Hopkins University).

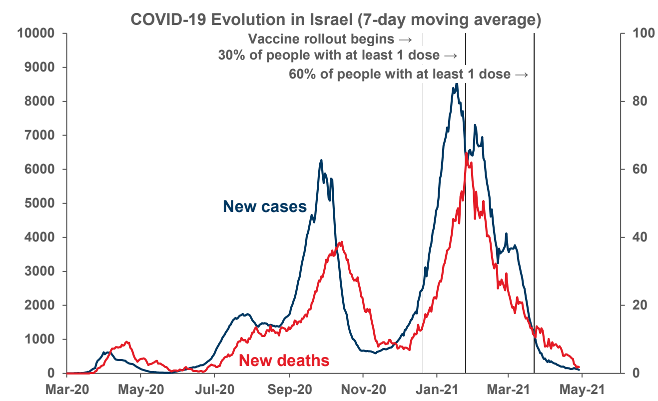
Regarding this last point, data from Israel – the most advanced country in its vaccination campaign with almost 63% of its population having received at least one dose – show that the country seems, for the moment, to have effectively defeated COVID-19 (Chart 4).

3. ... as global vaccination accelerates…



CIO Office (data via Our World in Data).

4. … revealing its effectiveness



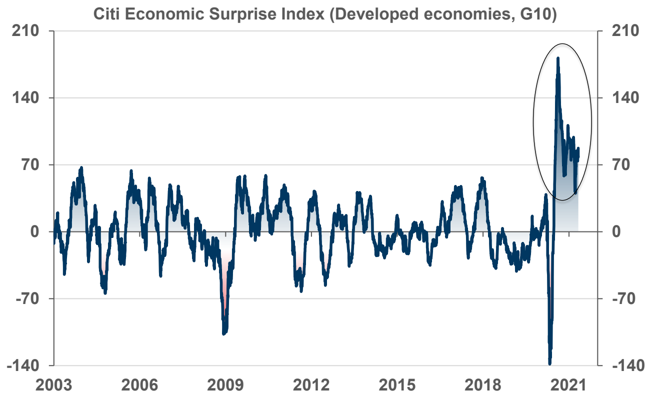
CIO Office (data via Our World in Data, Johns Hopkins University).

Meanwhile, the latest economic figures, which carried some downside risks given the maintenance of several containment measures in developed countries during the winter months, turned out better than expected. In fact: the G10 Economic Surprise Index remains not only positive, but also close to a record high – and this has been the case for 11 consecutive months now (Chart 5, next page).

Concretely, one economic figure that has been surprisingly strong lately is U.S. retail sales, which soared in March to a whopping 17% above their pre-crisis level (Chart 6, next page). Clearly, this is

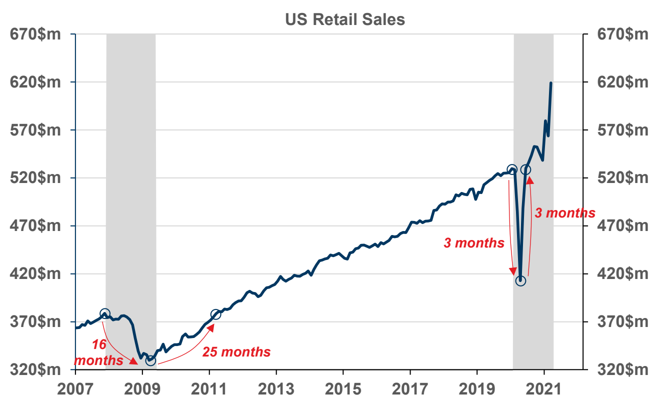
[1] Vaccines Are Working: Charts that Show the COVID Endgame, Financial Times, April 21, 2021.

5. Economic surprises remain largely positive…



CIO Office (data via Refinitiv).

6. ... as evidenced by U.S. retail sales figures

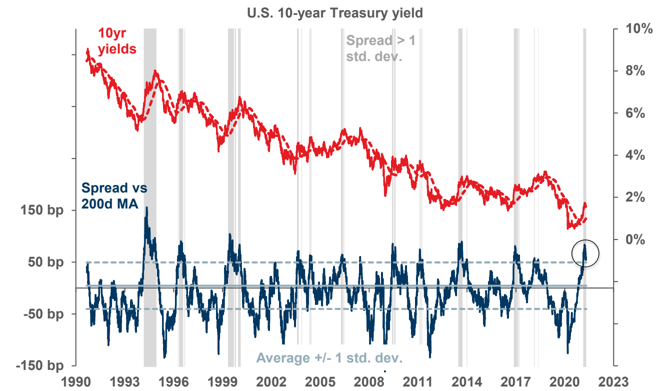


CIO Office (data via Refinitiv).

a result of the one-time stimulus checks included in the Biden administration's recovery package passed the very same month. We should, therefore, expect to see subsequent retail sales figures fall back to earth. Nonetheless, it does demonstrate how the current economic rebound is light-years away from the weak recovery that followed the financial crisis.

However, what really made April a clement month for risk assets was the fact that despite the abundance of strong economic data, Treasury yields actually took a breather, easing back slightly. As we mentioned in last month's report, the magnitude of their rise in Q1 signalled at least a stabilization in the short term (Chart 7), and it does indeed appear that the move lower in April was only technical in nature.

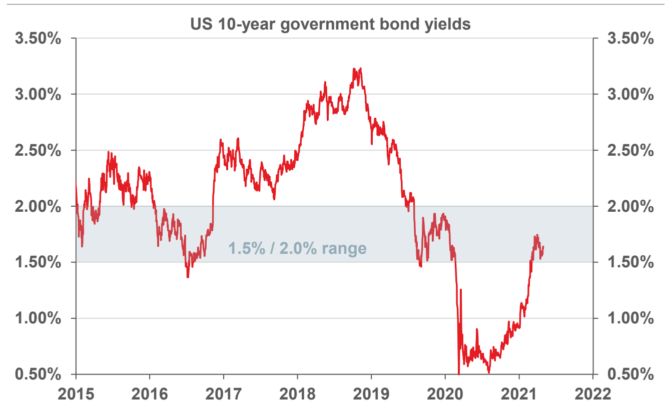
7. Technical breather for Treasury yields…



CIO Office (data via Refinitiv).

Accordingly, we should not expect rates to drop much further in the coming months. Our base-case scenario continues to call for U.S. 10-year Treasury yields to remain in the 1.5% to 2.0% range for the remainder of the year, roughly the levels that prevailed in the months preceding the pandemic (Chart 8). Besides, the likelihood of rates testing the top of this range at some point in 2021 appears more probable than the opposite, in our view – all depending on the "weather" this summer.

8. … settling into their pre-pandemic range



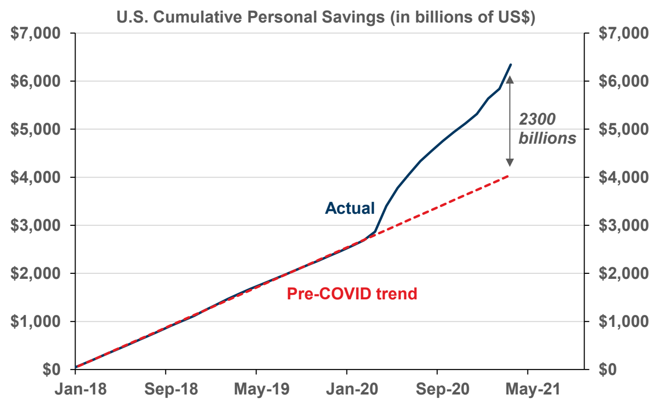
CIO Office (data via Refinitiv).

… and a hot Summer ahead

Is the mild Spring a harbinger of a hot Summer? It appears so, both literally[2] and figuratively for the economy.

For instance, the accumulation of sizeable savings since the onset of the pandemic – about $2.3 trillion above the pre-COVID trend in the U.S., or ~11% of GDP (Chart 9) – accentuated by the second round of U.S. stimulus in March highlights the potential for a strong pick-up in aggregate demand in the quarters ahead.

9. Households are in a position of strength…

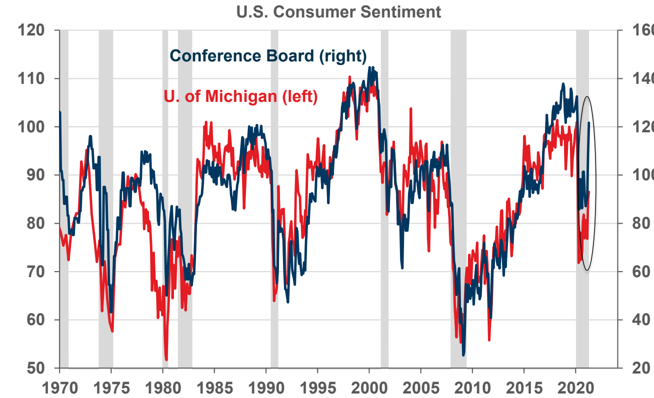


CIO Office (data via Refinitiv).

Assuming the health situation allows for a gradual reopening of the vast majority of economic activity over the coming months (which is not a certainty), one should not believe that all of the excess savings will be converted into consumer spending overnight. However, healthier household balance sheets do suggest a greater capacity to spend additional income when economies do reopen, provided that consumer confidence is high enough. Judging by the latest readings on this matter, it appears this will be the case – the U.S. Conference Board Consumer Confidence Index increase over the last two months is its biggest since 1974 (Chart 10).

While it is fairly clear that the string of robust economic data will extend into the Summer, the same holds for inflation figures. In fact, it is during the current and next month that the base effects we

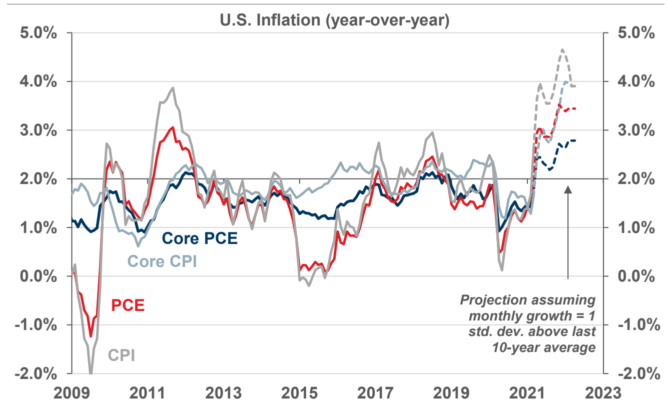
10. … and their sentiment is improving quickly



CIO Office (data via Refinitiv).

discussed in our last report are certain to reveal year-over-year increases well above 2% (Chart 11).

11. Higher inflation straight ahead...



CIO Office (data via Refinitiv).

Now, will this inevitable jump in prices be transitory or the beginning of something more lasting? That's the question of the hour, but the reality is that for the coming year, what matters isn't so much what *we* think, but what central bankers think. In this regard, Federal Reserve Chairman Jerome Powell never misses an opportunity to reiterate his institution's view that "*one-time increases in prices are likely to only have transitory effects on inflation*." [3]

While this approach may seem complacent, it's important to recall that U.S. core inflation has remained below target for most of the past decade.

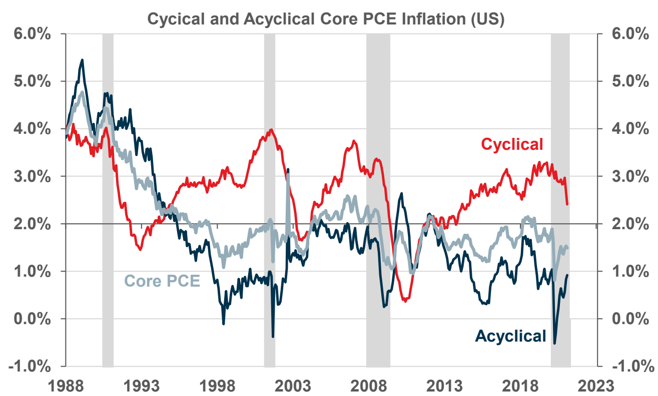
[2] Summer 2021: Warm and Stormy Weather Ahead, Farmers' Almanac (should be taken with a grain of salt…!).

[3] Fed Holds Interest Rates Near Zero, Sees Faster Growth and Higher Inflation, CNBC, April 28, 2021.

Thus, a relatively higher rate of inflation for an extended period of time would only bring the long-term average closer to the 2% target – good news from the Fed's perspective.

But more importantly, recent research by the San Francisco Fed led policy makers to conclude that the low inflation of the last decade is largely explained by factors independent of the business cycle (i.e. acyclical, **Chart 12**).

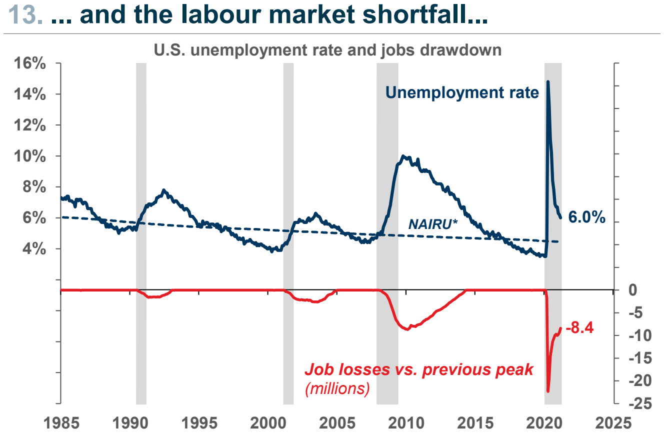
12. ... but the experience of the last decade...



CIO Office (data via Federal Reserve Bank of San Fransisco).
https://www.frbsf.org/economic-research/indicators-data/cyclical-and-acyclical-core-pce-inflation/

Why is this important? Because it means that the Fed is now willing to let the business cycle run at full throttle while keeping an accommodative monetary policy stance not only now, but even as labour market conditions tighten. With total jobs roughly 8 million below their January 2020 level, U.S. employment still has a long way to go before it even qualifies as tight in the eyes of the Fed (**Chart 13**).

13. ... and the labour market shortfall...

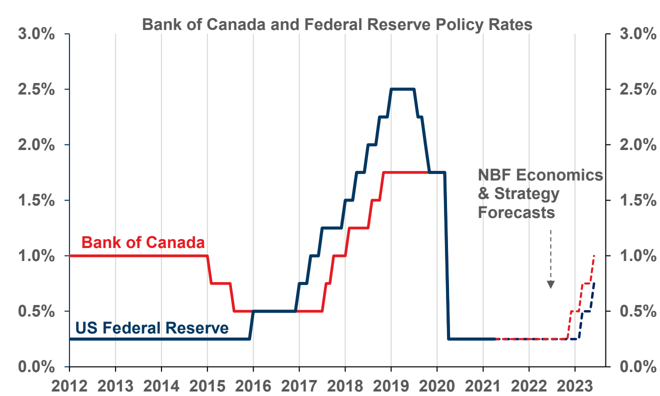


CIO Office (data via Refinitiv). *NAIRU = Non-accelerating inflation rate of unemployment.

What if price increases turn out to be more than transitory and far exceed Federal Reserve expectations? FOMC members know they could reach into their inflation-fighting toolbox, which is far better equipped than their deflation-fighting toolbox (just ask Japan...).

That said, the fact that the major central banks are expected to maintain accommodative policies for a few more years does not mean they will not make any adjustments to their current ultra-accommodative stance. The Bank of Canada's recent decision to scale back its asset purchase program and to open the door to a rate hike in the second half of 2022 is a good example of the kind of adjustment to expect. For his part, Powell commented on April 28 that it was "not time yet" to discuss tapering. Still, we should expect the Fed to start reducing its purchases in early 2022, while a first increase is likely in early 2023 (**Chart 14**) – two adjustments it will seek to communicate to markets several months in advance.

14. ... should lead the Fed to show some patience

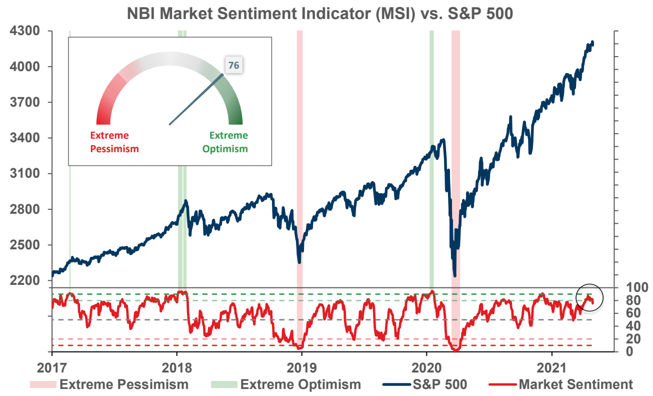


CIO Office (data via Refinitiv, NBF Economics and Strategy).

Investment conclusions

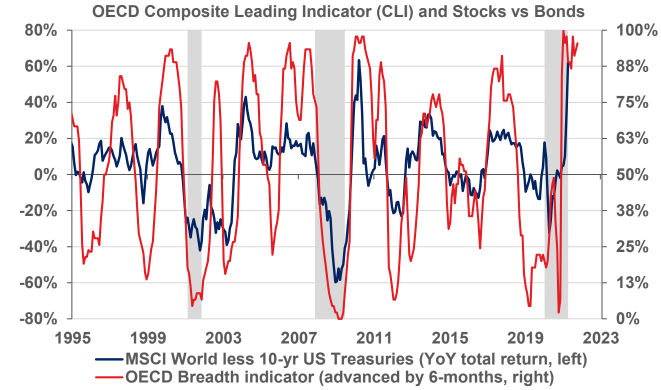
If conditions have been rather ideal for risk assets so far this Spring, the looming economic heat this Summer could prove uncomfortable at times, should markets have doubts about the transitory nature of rising inflation. Besides, while not excessive, the relatively high level of our sentiment indicator implies an increased vulnerability of stock prices to any bit of bad news in the short term (**Chart 15**, next page). For instance, negative

15. Market optimism is relatively high



CIO Office (data via Refinitiv, Bloomberg).

17. … and globally

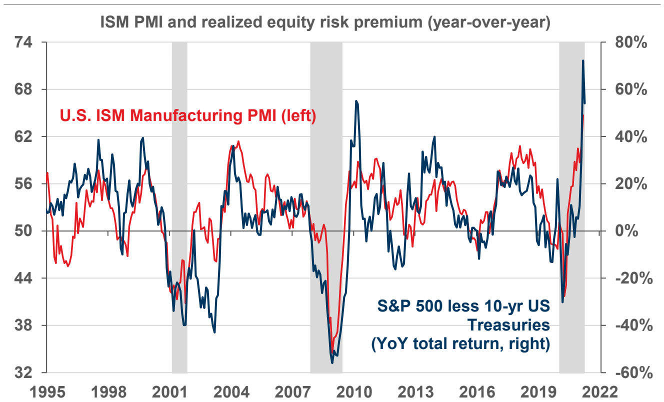


CIO Office (data via Refinitiv).

surprises on the pandemic front can't be ruled out until it’s over... and the dramatic situation in India shows that it clearly isn’t.

Fundamentally though, the acceleration in the vaccination campaign together with a mix of accommodative monetary and fiscal policies should result in a period of strong economic growth over the remainder of the year. Accordingly, equity markets should continue to outperform defensive bonds, as suggested by the Manufacturing PMI in the U.S. (Chart 16) and globally by the OECD's Breadth Indicator (Chart 17).

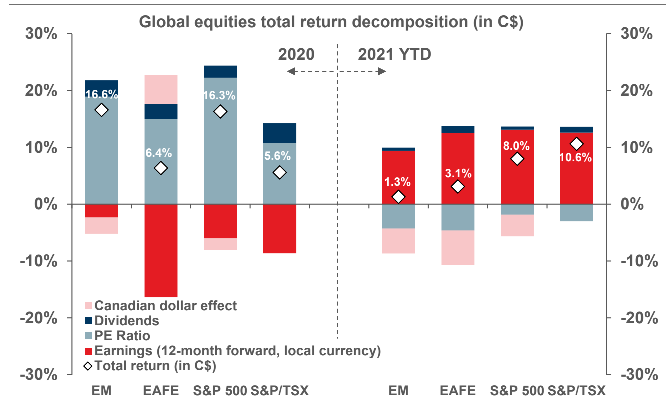
16. The economic backdrop is pro-risk in the US…



CIO Office (data via Refinitiv).

Of course, investors must temper their return expectations as the primary driver of growth for stock prices should be earnings, not valuations. In fact, this is what we stated in our 2021 outlook published last December, and it is precisely what has happened since the beginning of the year (Chart 18).

18. It's all about earnings in 2021...



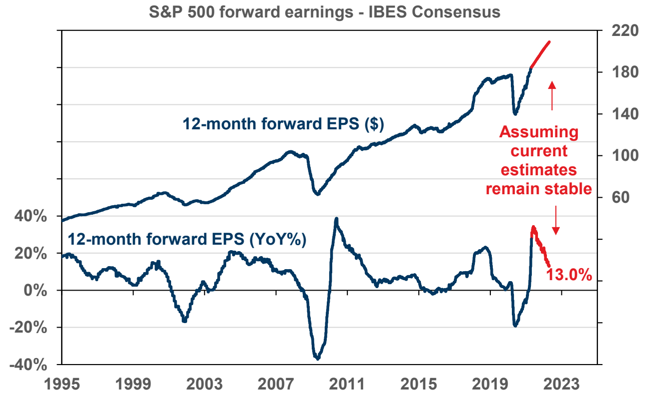
CIO Office (data via Refinitiv).

For the U.S. stock market, current estimates project a growth potential of about 13% over the next 12 months (Chart 19, next page), which would be more than enough to outperform bonds, whose risk/reward has improved year-to-date, but still remains relatively poor (Chart 20, next page).

Against this backdrop, we are keeping our asset allocation unchanged and continue to watch for opportunities to increase our equity overweight.

Geographically, the health situation in India poses an additional risk to our overweight in emerging markets (EM), given that India accounts for ~9% of the index. For now, the situation appears too concentrated and advanced to warrant a second reduction in our emerging markets allocation (our

19. ... and the outlook is looking positive...



CIO Office (data via Refinitiv).

20. ... especially in comparison to safer bonds

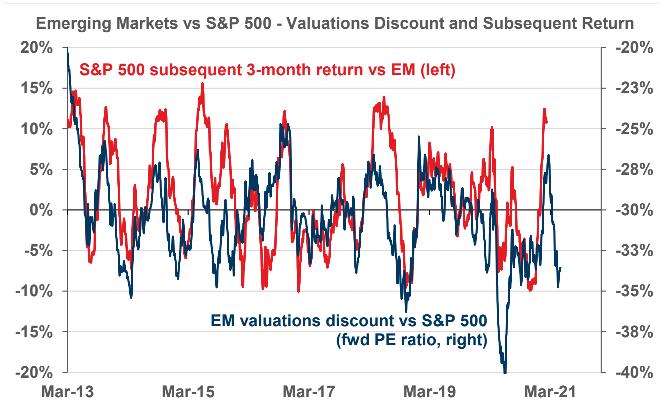
Expected 1-year Total Return from Interest Rate Changes

Rate Change	U.S. 10-year Bond	Canada 10-year Bond	Germany 10-year Bond	Japan 10-year Bond	FTSE Can. Universe*
100bps	-6.6%	-6.7%	-9.2%	-8.9%	-5.3%
80bps	-4.8%	-4.9%	-7.4%	-7.0%	-3.8%
60bps	-2.9%	-3.1%	-5.5%	-5.1%	-2.2%
40bps	-1.1%	-1.2%	-3.6%	-3.2%	-0.6%
20bps	0.7%	0.6%	-1.8%	-1.3%	0.9%
0bps	2.6%	2.5%	0.1%	0.6%	2.5%
-20bps	4.4%	4.3%	2.0%	2.6%	4.1%
-40bps	6.2%	6.1%	3.8%	4.5%	5.6%
-60bps	8.0%	8.0%	5.7%	6.4%	7.2%
-80bps	9.9%	9.8%	7.6%	8.3%	8.8%

CIO Office (data via Refinitiv, iShares). Total Return is measured as the sum of Starting Yield, Roll Yield, and Rate Change impact (assuming only parallel shifts in the yield curve). *For IG bonds, which represent approximately 30% of the index, we assume no change in their spread against government securities. As of April 26, 2021.

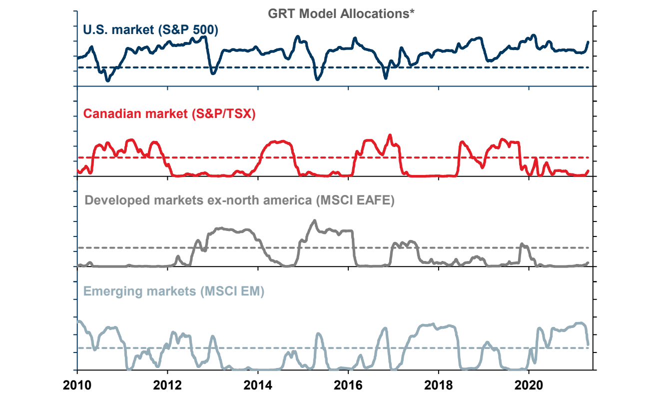
update on EM last month already led us to reduce our position in favour of Canada). The valuations gap is still in their favour on a 3-month horizon (Chart 21), but we continue to monitor relative trends (Chart 22) and do not exclude further adjustments in our geographical asset mix in the weeks and months to come.

21. Valuations still favourable to emerging markets...



CIO Office (data via Refinitiv).

22. ... but trends are evolving quickly



CIO Office (data via Refinitiv). *vs equally weighted index

Table 3 Base Case Scenario

Scenario (prob.*)	Key elements and investment implications
Base case (70%)	The coronavirus vaccination campaign provides immunization for the vast majority of the most-at-risk population in developed countries by the end of Q1-2021 and takes us near herd immunity mid-year. COVID-19 gradually becomes a secondary issue as pressure on the health care network subsides.
	The strong global cyclical recovery continues. After a more challenging start of the year due to containment measures, the pace of growth accelerates in Q2-2021, driven by a gradual and permanent reopening of the economy, a rise in consumer sentiment, and a recovery in the service sector.
	Central banks ensure highly accommodative monetary conditions as inflationary pressures remain muted. Asset purchases are extended and even increased if need be.
	The majority of developed countries policy makers maintain a significant level of fiscal support to businesses and consumers.
	→ **Bond yields remain stable while the U.S. dollar depreciates. Global equities continue to rise along their long-term trend. Leadership remains volatile but edge in favor of cyclical and emerging markets equities. Mega-cap stocks lag.**
Bullish (15%)	A multiplication of high-efficacy vaccine alternatives speeds up the immunization process. Countries remove the bulk of their containment measures earlier than expected.
	The reopening of economies following a definitive victory against COVID-19 reveals an unsuspected pent-up demand. Consumer sentiment surges; excess savings accumulated during the pandemic translate into consumer spending. Inflation rises, albeit not high enough to cause discomfort among central banks, which keep their rates unchanged.
	→ **Bond yields rise modestly while the U.S. dollar depreciates. Global equities surge above their long-term trend. Small caps, cyclical, emerging markets and EAFE equities significantly outperform.**
Bearish (15%)	Vaccination campaigns are delayed. The slowdown in economic growth expected in Q1-2021 extends into Q2-2021 due to an increase in COVID-19 cases, the extension of containment measures, and a sharp drop in consumer sentiment.
	The new Biden administration reveals a few surprises in its first 100 days. Uncertainty over U.S. fiscal policy, Big Tech regulations and/or sino-american relations force markets to recalibrate their expectations.
	→ **Bond yields fall and the U.S. dollar shoots higher. Equities venture in correction territory. Leadership shifts to government and high-grade bonds. Defensive stocks outperform.**

CIO Office. Last update: January 4, 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).

CIO Office
CIO-Office@nbc.ca

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

Louis Lajoie
Investment Strategist
louis.lajoie@bnc.ca

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

Nicolas Charlton
Analyst
nicolas.charlton@bnc.ca

General