Asset Allocation Strategy

CIO Office | September 2021

From risk-on to risks on the rise?

Highlights

- The investment backdrop remained risk-friendly during the summer months, as evidenced by the spectacular resilience of the S&P 500. It has now been almost ten months since the U.S. stock market last experienced a decline of at least 5%, something that historically happens every three months, on average.
- On the economic front, the latest corporate earnings have come in very strong, job creation has gained traction, and short-term inflation expectation measures have started to recede. Yet, uncertainty is on the rise on several fronts.
- It is increasingly clear that the COVID-19 pandemic will continue to cloud the outlook in the short to medium term. In addition, a shift in global monetary policies is likely to exert downward pressure on economic activity in the coming quarters. Meanwhile, the Global Economic Surprise Index just crossed into negative territory for the first time since June 2020.
- Overall, we remain relatively optimistic on the potential for equities to outperform over a cyclical horizon, with recession risks still distant. That said, after a fairly profitable period, the near-term risk/return outlook is no longer as compelling. As such, we have slightly reduced our overweight in equities in favour of cash as a means of adding an extra degree of caution to our pro-risk positioning.
- Although valuations of emerging countries remain attractive, the extent of uncertainty suggests that markets may need to wait for more clarity on the part of Chinese policymakers before repricing them at higher multiples. What's more, our macro model has recently stopped advocating for EM. This motivates our return to neutral in the region. In return, we have adopted a slight overweight in Canadian equities, which show persistent relative momentum.

Table 1 Global Asset Allocation Views

	– ⟵ = ⟶ +	Δ
Asset Classes		
Cash		↑
Fixed Income		
Equities		↓
Alternatives		
Fixed Income		
Government		
Investment Grade		
High Yield		
Duration		
Equities		
Canada		↑
United States		
EAFE		
Emerging Markets		↓
Value (vs. Growth)		
Small (vs. Large)		
Cyclicals (vs. Defensives)		
Alternatives & FX		
Inflation Protection		
Gold		
Non-Traditional FI		
Uncorrelated Strategies		
Canadian Dollar		

This table is for illustration purposes only. Bars represent the degree of preference of an asset 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

- Government Bond performances were marginally negative in August, as the U.S. 10-year benchmark rate closed out the month a few basis points higher despite an uptick in volatility.
- On the credit side, Investment Grade (down 0.2%) and High-Yield (up 0.5%) products also weathered an uptick in spread volatility, finishing the month relatively unchanged.

Equities

- U.S. stocks continued their impressive grind upwards to new heights in August, marking nearly 10 straight months without a decline below -5% for the S&P 500.
- Nearly every sector improved, helping the U.S. outperform other major geographies over the last month.
- Meanwhile, Canadian Equities faced greater cross-sectional dispersion than their southern cousins, with the IT (5.8%) and Communication Services (3.9%) sectors leading the pack against lagging Materials (-2.8%) and Consumer Discretionary (-1.3%) sectors.

FX & Commodities

- WTI proved to be resilient last month, bouncing back from its 200-day moving average but still finishing 7.2% below July's close.
- Meanwhile, the Loonie hit a low of 78 cents U.S. in August, as uncertainty regarding a fourth COVID-19 wave has continued to favour currencies perceived as safer, such as the USD.

Table 2 Market Total Returns

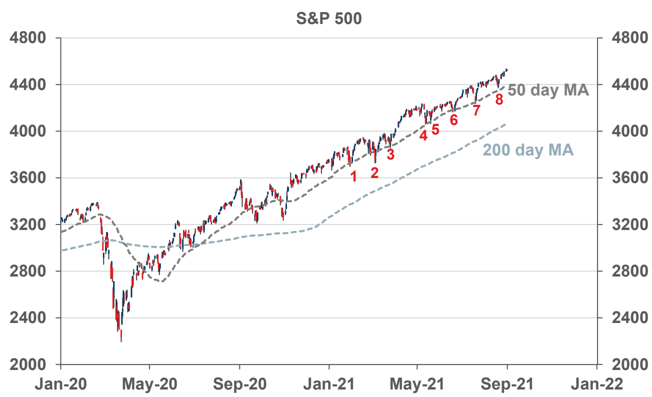
Asset Classes	August	YTD	12 MTH
Cash (3-month T-bills)	0.0%	0.1%	0.1%
Bonds (FTSE CA Univ.)	**-0.1%**	**-2.6%**	**-1.7%**
FTSE CA Short term	0.1%	-0.1%	0.5%
FTSE CA Mid term	0.0%	-1.7%	-0.6%
FTSE CA Long term	-0.4%	-6.3%	-5.2%
FTSE CA Government	-0.2%	-3.0%	-2.4%
FTSE CA Corporate	0.0%	-1.3%	0.4%
BoAML Inv. Grade ($US)	-0.2%	-0.1%	2.7%
BoAML High-Yield ($US)	0.5%	4.6%	10.3%
Preferred Shares	1.1%	16.4%	25.1%
CA Equities (S&P/TSX)	**1.6%**	**20.2%**	**28.2%**
Energy	-0.4%	29.6%	32.2%
Industrials	3.7%	14.0%	25.9%
Financials	1.8%	26.1%	42.0%
Materials	-2.8%	-0.4%	-6.8%
Utilities	1.0%	9.1%	22.5%
Cons. Disc	-1.3%	14.6%	41.4%
Cons. Staples	2.0%	18.5%	20.5%
Healthcare	1.1%	9.6%	30.5%
IT	5.8%	32.6%	39.1%
Comm. Svc.	3.9%	22.9%	26.9%
REITs	2.0%	29.9%	43.6%
S&P/TSX Small Cap	0.3%	16.9%	37.7%
US Equities (S&P500 USD)	**3.0%**	**21.6%**	**31.2%**
Energy	-2.0%	30.9%	42.9%
Industrials	1.1%	18.8%	36.4%
Financials	5.1%	31.6%	56.5%
Materials	1.9%	19.1%	38.1%
Utilities	4.0%	11.1%	19.7%
Cons. Disc	2.1%	13.2%	17.8%
Cons. Staples	1.4%	9.2%	14.4%
Healthcare	2.4%	20.1%	27.0%
IT	3.6%	22.4%	29.5%
Comm. Svc.	5.0%	30.2%	38.6%
REITs	2.8%	32.6%	36.4%
Russell 2000 (USD)	2.1%	15.1%	45.6%
World Eq. (MSCI ACWI)	**2.5%**	**16.2%**	**29.2%**
MSCI EAFE (USD)	1.8%	12.0%	26.7%
MSCI EM (USD)	2.6%	3.1%	21.5%
Commodities (CRB index)	**0.0%**	**30.1%**	**42.5%**
WTI Oil (US$/barrel)	-7.2%	42.1%	61.0%
Gold (US$/ounce)	-0.9%	-4.8%	-8.2%
Copper (US$/tonne)	-1.8%	23.0%	42.3%
Forex (DXY - USD index)	**0.5%**	**3.0%**	**0.5%**
USD per EUR	-0.5%	-3.5%	-1.3%
CAD per USD	1.2%	-0.9%	-3.3%

Data via Refinitiv 2021-08-31

Taking stock of markets…

The investment backdrop remained risk-friendly during the Summer months, as evidenced by the spectacular resilience of the S&P 500. The stock Market Index has challenged its 50-day moving average three times since June and eight times since the beginning of the year, bouncing higher on all occasions (**Chart 1**).

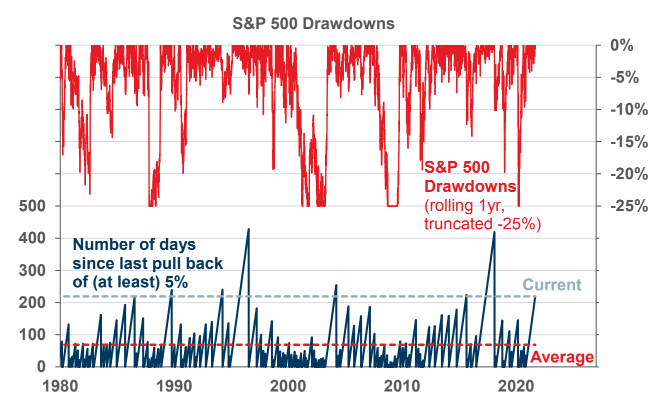
1 | U.S. equities continue to bounce higher…



CIO Office (data via Refinitiv).

It has now been almost ten months (219 business days) since the U.S. stock market last experienced a decline of at least 5%, something that historically happens every three months, on average (**Chart 2**).

2 | … without too much trouble



CIO Office (data via Refinitiv).

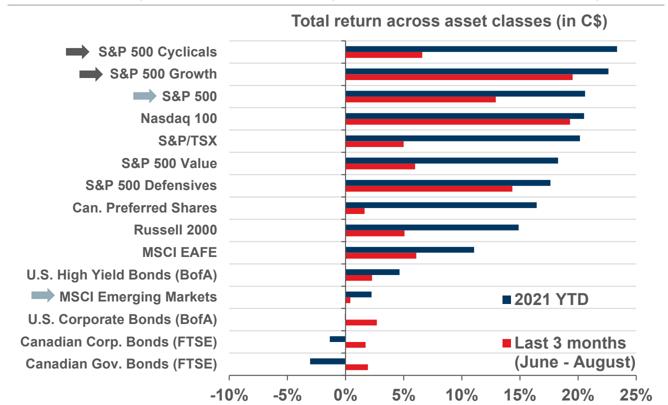
While risk appetite remained high, demand for safer assets such as U.S. Government Bonds also proved to be strong. Accordingly, 10-year Treasury yields continued to decline in July and rose only modestly in August, a downward trend trend favouring more defensive and growth stocks (**Chart 3**).

3 | Demand for safer assets remains strong

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

Indeed, while the cyclical sectors of the S&P 500 remain among the top-performing assets year-to-date, the last three months have seen their competition with growth stocks tighten significantly. Concurrently, the gap between the dominant U.S. market and foreign equities – particularly Emerging Markets – has widened to the advantage of our neighbours to the south (**Chart 4**).

4 | Some gaps are closing, others are widening

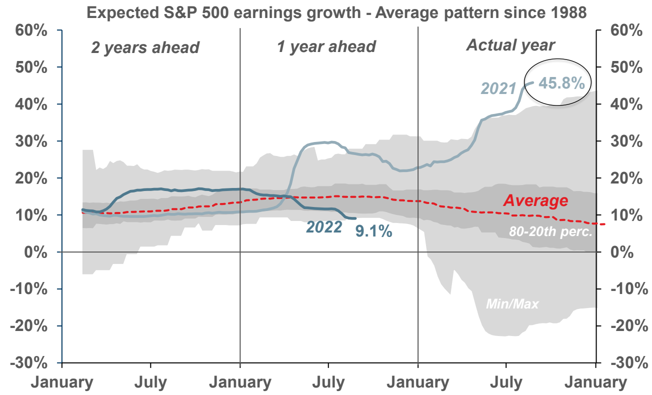


CIO Office (data via Refinitiv).

… and the economic backdrop

On the economic front, the latest corporate earnings have come in very strong. The S&P 500's expected earnings growth for 2021 now stands at 46%, the highest since records began (**Chart 5**, next page).

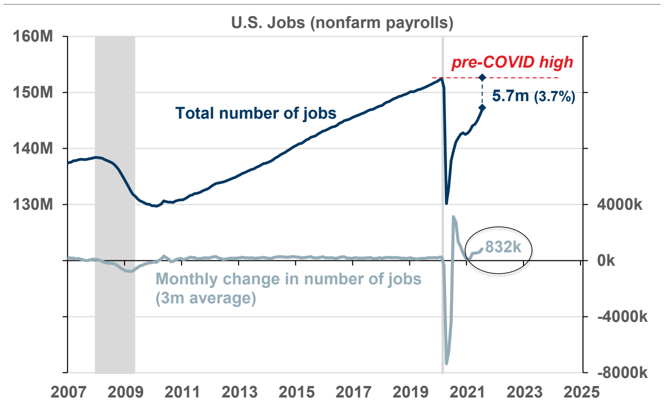
5 | Earnings growth on track for a record high



CIO Office (data via Refinitiv).

U.S. job creation, which is of primary importance given its influence on the future path of U.S. monetary policy, has gained traction with an average monthly increase of +832k over the past three months. At this pace, employment could return to pre-pandemic levels by March 2022 (**Chart 6**).

6 | The jobs recovery is gathering pace...

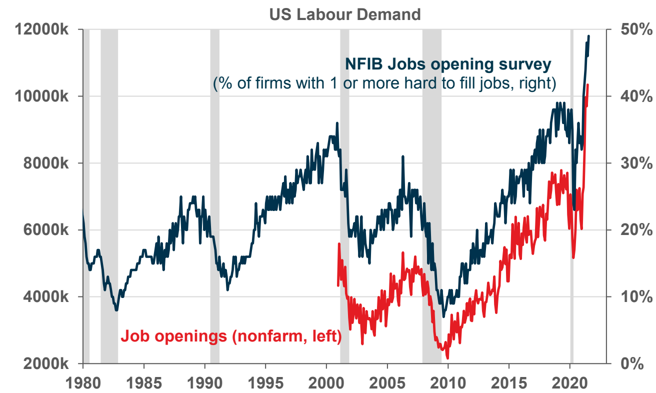


CIO Office (data via Refinitiv).

Clearly, the issue is not demand for workers – there are more than 10 million job openings (**Chart 7**) – but rather supply, an imbalance that should ease with the expiration of enhanced unemployment benefits and the return of in-person teaching this Fall.

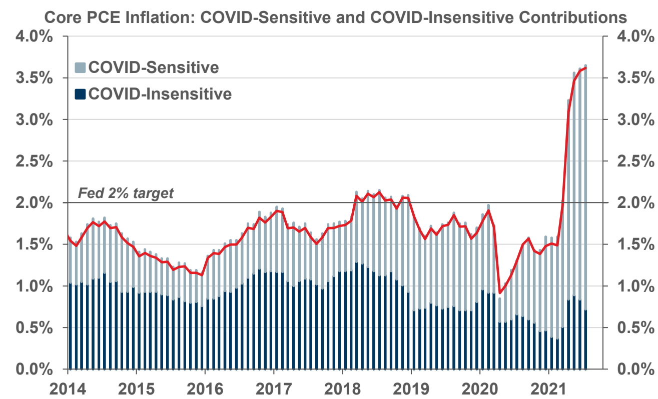
As for inflation, figures remained high for the most part. Yet, price increases still appear to be largely influenced by factors specific to the pandemic, as highlighted by an analysis from the San Francisco Federal Reserve (**Chart 8**).

7 | ... while demand for workers abounds



CIO Office (data via Refinitiv).

8 | Inflation remains sensitive to the pandemic...

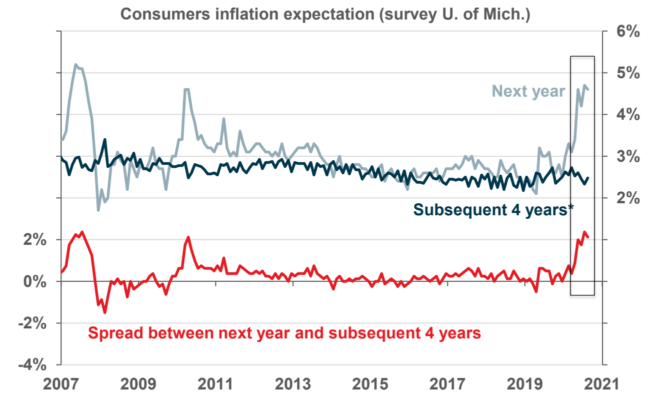


CIO Office (data via Refinitiv, Federal Reserve Bank of San Francisco).

In this context, and as we discussed in our June report, forward-looking measures are most important given their relevance to the Fed and the self-fulfilling potential of inflation. News in this regard is relatively positive: short-term consumer expectations appear to be peaking (**Chart 9**, next page) while market expectations have started to recede (**Chart 10**, next page). In both cases, long-term readings remain stable.

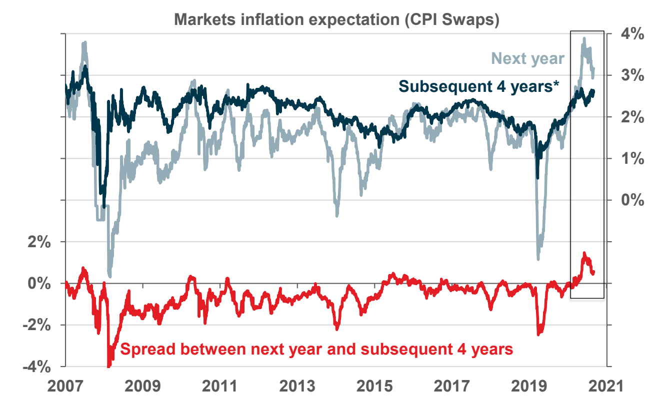
In sum, the macro-financial picture remained rather benign over the Summer, with most assets recording gains and the economic recovery proceeding without major hiccups. Yet, uncertainty is on the rise on several fronts.

9 | … but consumers' expectations are peaking…



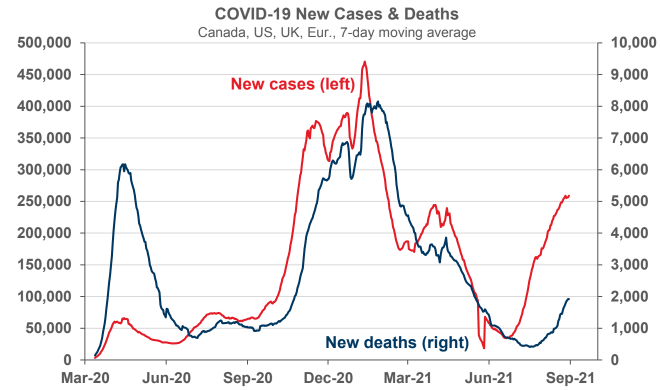
CIO Office (data via Refinitiv). *Implicit measure based on 1-year and 5-year inflation expectations.

10 | … and markets' expectations are receding



CIO Office (data via Refinitiv). *Implicit measure based on 1-year and 5-year CPI swaps.

11 | The pandemic continues to cloud the outlook…

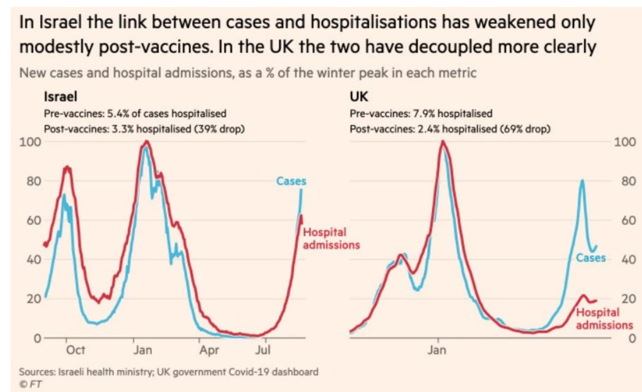


CIO Office (data via Johns Hopkins University).

Risks on the rise

Without returning to crisis status, it is increasingly clear that the COVID-19 pandemic will continue to cloud the outlook in the short to medium term. For now, the spread of the Delta variant in developed countries has been met with a moderate increase in deaths (**Chart 11**). However, recent data out of Israel – the first country to reach vaccination coverage of over 50% in March – points to a reduction in the efficacy of Pfizer's vaccine over time and against the Delta variant.[1] Cases and also hospitalizations are on the rise in the country that had abandoned virtually all forms of restrictions until recently.[2] By comparison, the situation in UK hospitals – a nation largely covered by AstraZeneca's vaccine – doesn't seem to be as problematic at the moment, as shown by data compiled by the Financial Times[3] (**Chart 12**).

12 | ... as evidenced by the situation in Israel

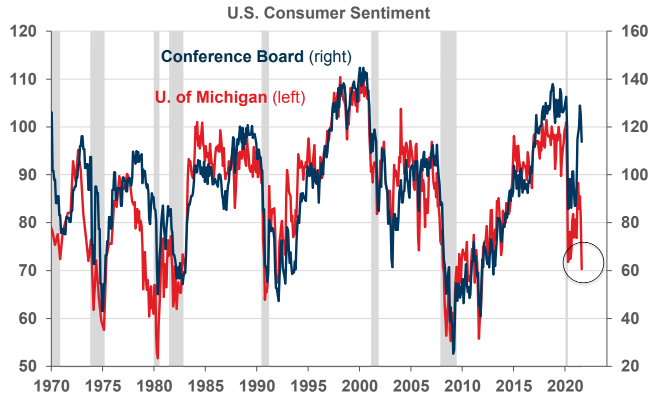


Source: Israeli health ministry, UK government, Financial Times.
https://www.ft.com/content/23cdbf8c-b5ef-4596-bb46-f510606ab556

Solutions, such as a third dose for people at higher risk, are already being put in place. Nevertheless, the likelihood that the health situation will undermine consumer sentiment (and thus economic recovery) is increasing as a result. In fact, the University of Michigan's Consumer Sentiment Index has already fallen sharply in the wake of the new wave of contagion in the past months (**Chart 13**, next page).

[1] Impact of Delta on viral burden and vaccine effectiveness against new SARS-CoV-2 infections in the UK, August 16, 2021.
[2] A grim warning from Israel: Vaccination blunts, but does not defeat Delta, Science mag, August 16, 2021.
[3] Israel hopes boosters can avert new lockdown as COVID vaccine efficacy fades, Financial Times, August 23, 2021.

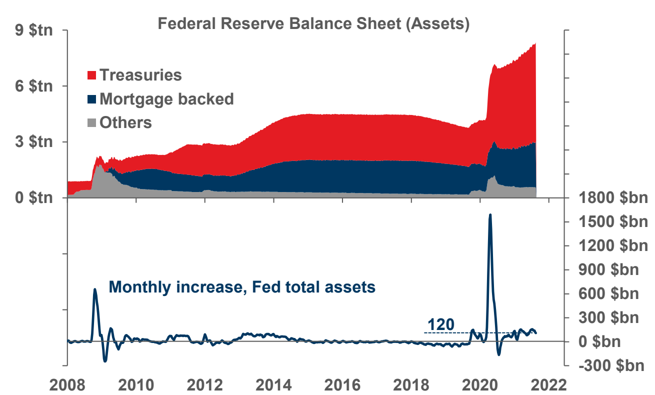
13 | Consumer sentiment is at risk



CIO Office (data via Refinitiv).

Meanwhile, uncertainty surrounding monetary conditions could also increase as the Fed should announce the start of a gradual reduction in its asset purchases by the end of the year (**Chart 14**). An early notice to this effect could come out as soon as at its next policy meeting on September 22, with a formal start in November or December.

14 | The Fed should soon slow its asset purchases…

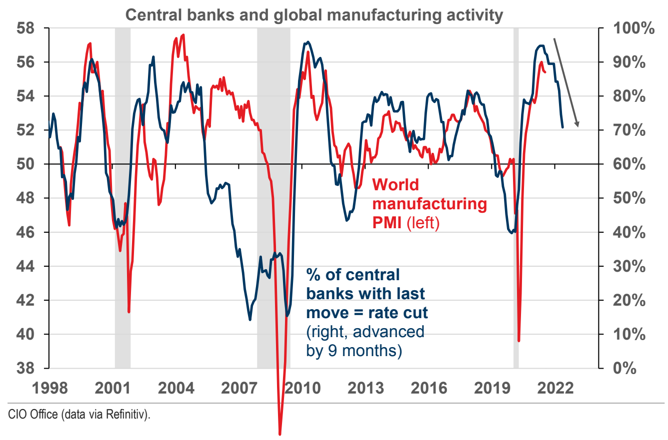


CIO Office (data via Refinitiv).

To be clear, the U.S. Central Bank policy is not about to become restrictive – we are merely looking at a first step from an "extremely accommodative" to "very accommodative" stance... conditional upon further progress in the labour market. The Fed should also continue communicating its intentions with extra caution, especially considering the persistent threat of a pandemic. It could even delay any decision on asset purchases if the epidemiological situation deteriorates considerably. A 'taper tantrum' à la 2013 – when an unscripted mention of a possible reduction in Fed asset purchases by then-Chairman Ben Bernake caused a stir in financial markets – is therefore unlikely.

Rather, the risk here is that this comes on top of a growing proportion of central banks having recently raised their policy rates (mainly in Emerging Markets for now), a policy shift that was already likely to exert downward pressure on global economic activity in the coming quarters (**Chart 15**).

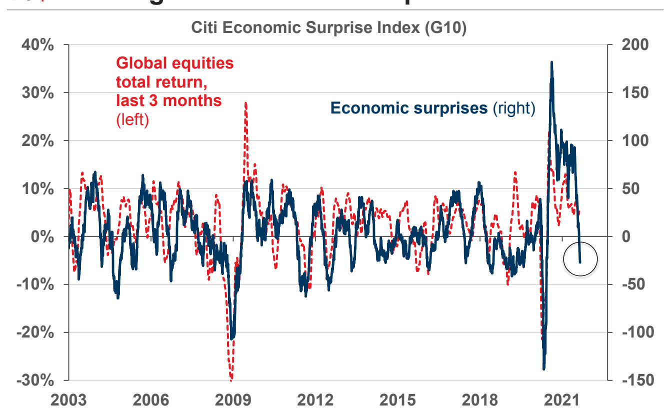
15 | ... while others have already raised their rates



CIO Office (data via Refinitiv).

Moreover, it appears that exceeding growth expectations is already becoming increasingly difficult. For the first time since June 2020, the Global Economic Surprise Index just crossed into negative territory, a typically more challenging environment for Equity markets (**Chart 16**).

16 | First negative economic surprises in 14 months

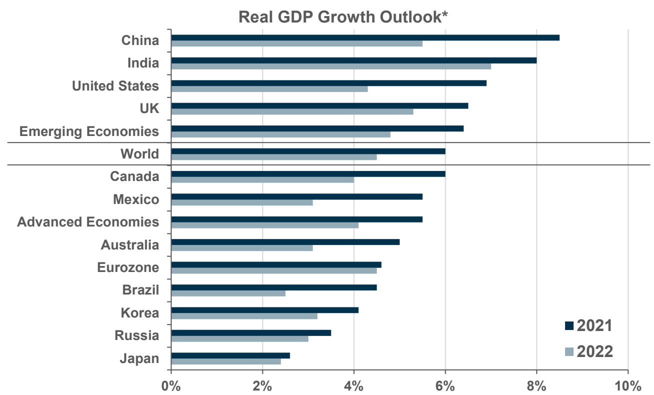


CIO Office (data via Refinitiv).

The bottom line

Global economic growth will inevitably slow in the coming months. It should nonetheless remain above its long-term trend (**Chart 17**),[4] supported by a substantial savings surplus, among other things. Consequently, we remain relatively optimistic on the potential for equities to outperform over a cyclical horizon, with recession risks still distant.

17 | Growth set to slow, but remain strong

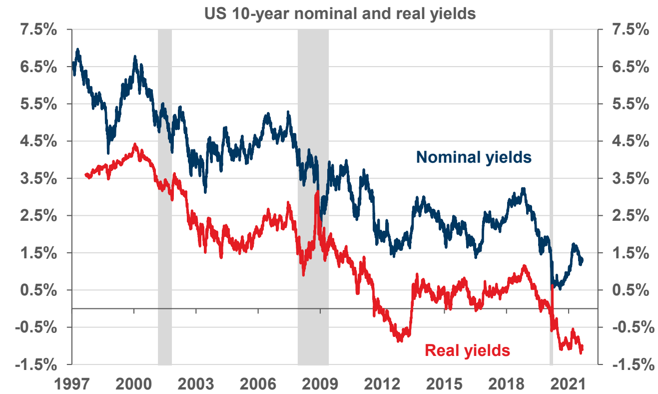


Source: *NBF Economics and Strategy Monthly Economic Monitor. July 15, 2021. Note that the September update of economic growth forecasts is likely to include downward revisions to the outlook for 2022.

That said, after a fairly profitable period, the near-term risk/return outlook is no longer as compelling. Heightened pandemic uncertainty along with shifts in monetary conditions have the potential to add to the recent string of negative economic surprises. Furthermore, any upward moves in real rates (which recently hit a new all-time low, **Chart 18**) would not only pose a challenge for bonds, but also for equities, whose valuations depend on the measure (**Chart 19**). As such, we have slightly reduced our overweight in equities in favour of cash as a means of adding an extra degree of caution to our pro-risk positioning.

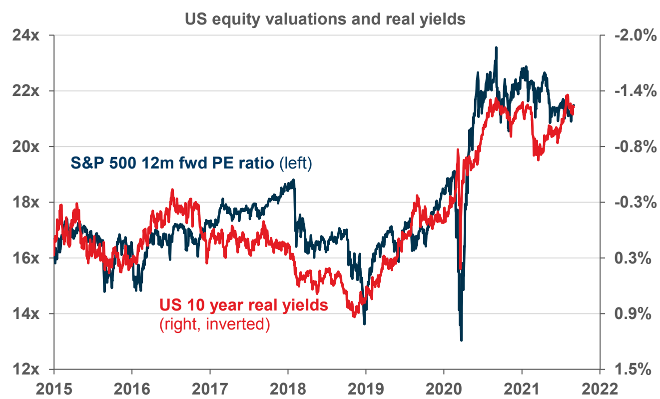
For Emerging Markets (EM), Chinese regulatory and technology stock risks contributed to our decision to reduce their allocation by one notch on April 1, though we remained overweight. Since then, Chinese authorities have surprised by the scale of the regulatory changes envisaged, despite an economy that is visibly weakening more rapidly than elsewhere (**Chart 20**).

18 | A potential move higher in rates...



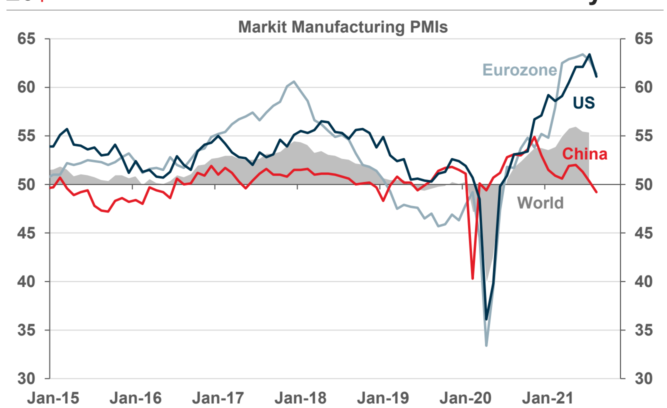
CIO Office (data via Refinitiv).

19 | ... would also challenge equity valuations



CIO Office (data via Refinitiv).

20 | Marked slowdown for the Chinese economy...

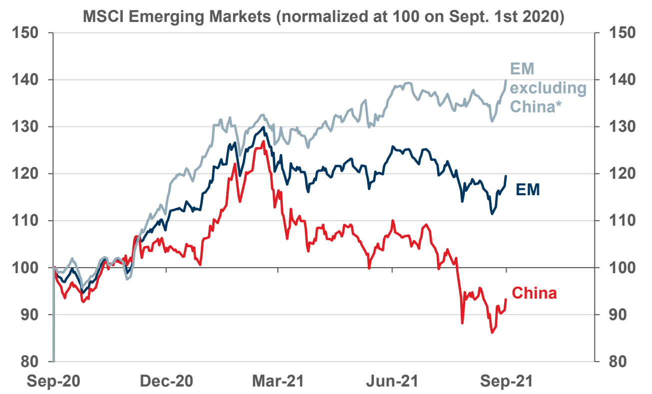


CIO Office (data via Refinitiv).

[4] NBF Economics and Strategy, July/August Monthly Economic Monitor

This confluence of events has proven difficult for the region, with Chinese Equities responsible for the bulk of the decline in the MSCI Emerging Markets Index since its February peak (**Chart 21**).

21 | … and its heavily weighted stock market

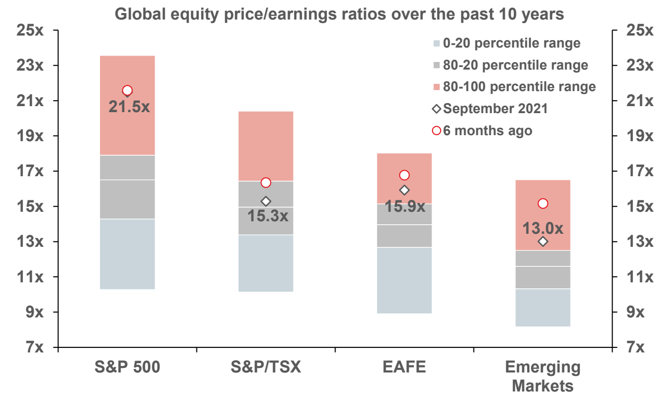


CIO Office (data via Refinitiv). *Estimated from a linear regression.

Although relative valuations of emerging countries remain attractive (**Chart 22**), the extent of uncertainty suggests that markets may need to wait for more clarity on the part of Chinese policymakers before repricing them at higher multiples. On this front, a key element to watch in the coming months will be the willingness Chinese authorities to put a floor under the economic slowdown via new policy easing measures. A first step in this direction came when the People's Bank of China (PBoC) cut bank reserve ratios last July, but more will likely be needed before a clear turning point for growth emerges (**Chart 23**). In the meantime, USD strength and a growing number of central banks having raised their policy rate caused our model that evaluates whether macro conditions are favourable to EMs to stop advocating for them recently (**Chart 24**). Overall, this motivates our return to neutral in Emerging Markets.

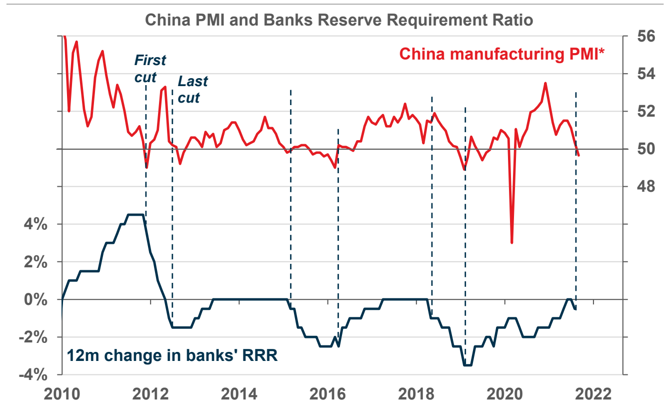
In return, we have adopted a slight overweight in Canadian equities, which show persistent relative momentum (**Chart 25**, next page), lower valuations (only market with a PE multiple close to its historical average, see Chart 22), and allow us to reduce our under-exposure to the Canadian dollar, which has been beneficial over the past three months.

22 | Divergences between equity valuations



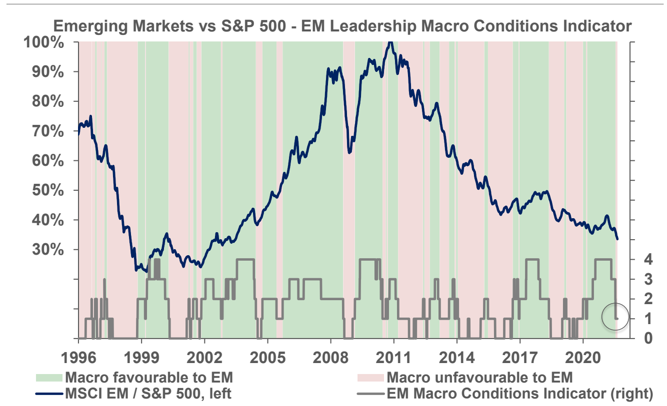
CIO Office (data via Refinitiv).

23 | Policy easing in China: more to come?



CIO Office (data via Refinitiv). *Average of Markit PMI and NBS since August 2018, NBS before.

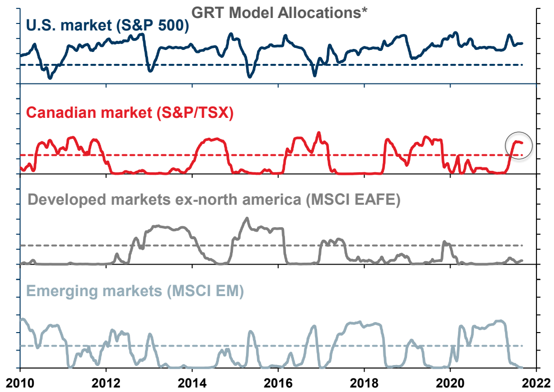
24 | The backdrop is getting more challenging for EM



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.

NATIONAL BANK INVESTMENTS

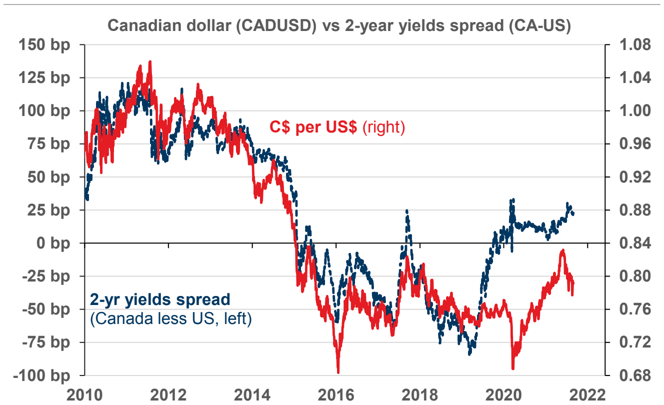
25 | Persistent relative momentum in Canada



CIO Office (data via Refinitiv). *vs equal weight benchmark.

After peaking near 83 cents U.S. ($1.20 CAD/USD) in May, the Canadian dollar hit a low of 78 cents U.S.($1.28 CAD/USD) in August. Bouts of risk aversion would certainly see the Loonie retreat further, but interest rate differentials continues to point to a strenghtening C$ beyond the immediate risks to the global economic outlook (**Chart 26**). In this regard, our colleagues at NBF Economics and Strategy project a modest appreciation to 81 cents U.S.($1.24 CAD/USD) by year-end.[5]

26 | Limited downside potential for C$.



CIO Office (data via Refinitiv).

[5] NBF Economics and Strategy, Monthly Forex, September 2021.

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 Allocation	Total Active Weight	Asset Class Allocation	Asset Class Active Weight	
Asset Classes							
Cash	0%	-	2.0%	2.0%	-	-	With above-trend global growth, 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 sustained inflation. A modest cash position provides an extra level of prudence, given relatively weak risk-reward prospects across asset classes. Overall, this positioning is pro-risk.
Fixed Income	40%	-	30.0%	-10.0%	-	-	
Equities	60%	-	63.0%	3.0%	-	-	
Alternatives	0%	-	5.0%	5.0%	-	-	
Fixed Income							
Government	28%	73%	16.8%	-11.2%	54%	-18.8%	Highly accommodative monetary conditions and a sustained 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 central banks begin to normalize their policies, but we expect real yields to remain negative.
Investment Grade	12%	27%	14.2%	2.2%	46%	18.8%	
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%	23.0%	2.0%	37%	1.6%	Prevailing uncertainty argues for a diversified approach in equities. Canada should outperform the U.S. under a backdrop of strong global growth and slightly higher rates. In EM, we favour cyclical and value sectors (RAFI Fundamental, 2.3%). In the U.S, we favour the high-quality (MSCI Quality, 4.5% weight) dividend-paying (Div. Aristocrats, 4%) companies and the equal weight index (3%) for their diversified properties.
United States	21%	35%	21.0%	0.0%	33%	-1.6%	
EAFE	12%	20%	12.6%	0.6%	20%	0.0%	
Emerging markets	6%	10%	6.3%	0.3%	10%	0.0%	
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%	-	57.0%	-4.0%	-	-	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 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%	-	4.8%	0.3%	-	-	
Japanese Yen	3%	-	3.2%	0.2%	-	-	
British Pound	2%	-	1.8%	0.1%	-	-	
Others	9%	-	9.2%	0.5%	-	-	

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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General

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