Asset Allocation Model – June Update

The end of May was marked by the decision of Trump administration to impose steel and aluminum tariffs on Canada, Mexico and the EU. This action may mark escalating trade tensions among key trading partners.

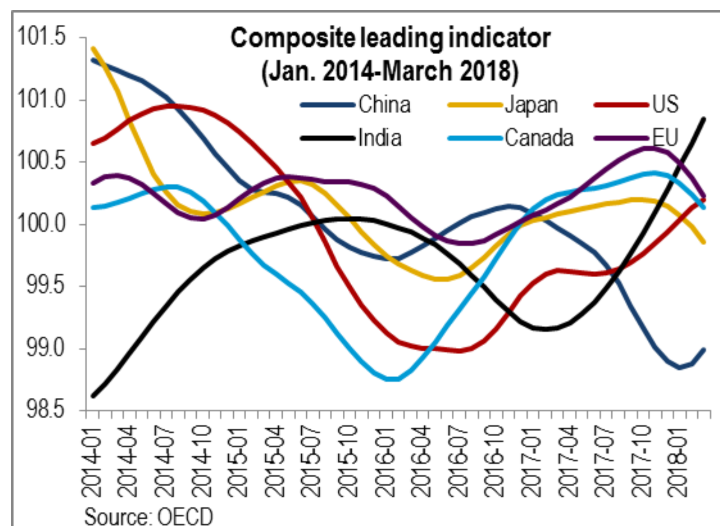
Beyond growing trade concerns, there are also other reasons to worry about the upbeat equity market outlook for 2018 and beyond. A tight labor market in the U.S., aggressive tax cuts and increased government spending could force the Fed to react quickly to prevent inflation from running too high, leading to higher interest rates and lower equity market multiples. Also, political developments in Italy, home of 4% of global debt, will need to be monitored closely although the latest European Union credit measures and leading indicator suggest sustained positive economic momentum.

The increase in market-based inflation expectations to new highs since September 2014 and more recent higher interest rates are also consistent with robust economic growth. However, we remain worried that growing headwinds for equities over the coming months could result in lower business investment due to intensifying trade disputes. The derailing of NAFTA talks (especially after the July 1st Mexican elections) as well as a deteriorating geopolitical environment with live crises in Iran, Syria, Venezuela, Libya and North Korea among other places, also justify remaining prudent. As a result, we maintain our neutral stance on equities for the month of June.

Regional Allocation & Sector Allocation

There are no major changes to our regional allocation this month with our largest overweight remaining Canadian and Emerging market equities. Canadian stocks remain historically cheap relative to U.S. equities and we continue to expect Canadian crude oil prices to rise further in 2018 on the back of a tightening global oil market and as constraints on market access in Canada get resolved. This being said, we will be monitoring the upcoming OPEC meeting in a few weeks to determine, after months of excessive compliance, by how much the agreement to cut production will be adjusted to meet global oil demand and how this adjustment will affect crude prices.

We also maintain our overweight in emerging markets as these remain cheap relative to developed markets. Macroeconomic conditions continue to be ideal for emerging markets, with low real interest rates, soft inflation measures, easy financial conditions and, for now, improving global trade flows. Both leading economic indicator (see graph below) and forward earnings for emerging markets are also accelerating relative to developed markets, which represent other tailwinds for EM equities.



Our sector allocation is unchanged for the month of June. We are recommending that clients overweight positions in the **Industrials**, **Financials**, **Energy** and **Consumer discretionary** sectors in the U.S. and Canada. For Canada, we also recommend keeping an overweight in the **Materials** sector and, in the U.S, the **Information Technology** sector. The energy sector could come under pressure if the OPEC meeting in June confirms that OPEC and Russia intent to relax crude production cuts early (the renewed agreement was intended to last until next December) by a large amount. However, we believe this was already priced in following the acknowledgment in mid-May by Russia and Saudi Arabia that lower oil inventories, having returned to their 5-year average, may justify increasing global crude supply in the coming months to avoid a price flare up. In our view, the beginning of driving season last week and further potential constraints on production in Venezuela and Iran should also help sustain WTI oil prices above $65 until the end of this year.

Canadian Bond Allocation

We also maintain our neutral stance on corporate bonds this month as valuation remains historically rich, especially when adjusted for elevated corporate leverage. We remain concerned by the unavoidable decelerating global economic momentum, the eventual slowdown in earnings growth and central banks withdrawing stimulus. All of these factors will ultimately hurt the relative performance of credit in the second half of the year. Moreover, growing apprehensions over geopolitical uncertainties and ongoing trade war hostilities could negatively impact the profit margin outlook of corporations. We are not calling for corporate spread to get wider in June. However, as they are historically tight with little to be gained in terms of further compression and, as the timing of a credit spread reversal is notoriously difficult to forecast, we prefer remaining neutral for now.

Model Portfolio as of June 2018				
Asset Classes & Regions	Recommended Weightings (%)	Benchmark Allocation (%)	Over/Underweights (%)	Recommendation
Bonds	50.0	50.0	0.0	=
Government	34.4	34.4	0.0	=
Corporate	15.6	15.6	0.0	=
Equities	50.0	50.0	0.0	=
Canada	22.0	20.0	2.0	+
United States	12.0	16.0	-4.0	-
Other Developed Markets	11.6	11.6	0.0	=
Emerging Markets	4.4	2.4	2.0	+

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