Laurentian Bank Securities ECONOMIC RESEARCH AND STRATEGY

Tactical Asset Allocation (Dec. Update): Optimism Still Prevails for the Time Being

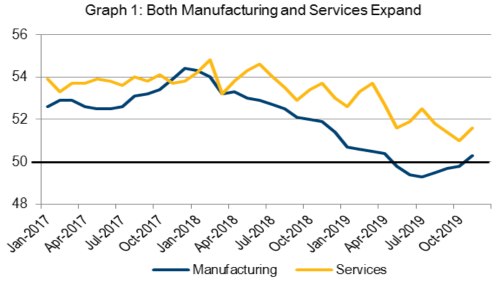
During the month of November, continued trade optimism and subsided recession fears resulted in gains for equities. Both the S&P 500 and the S&P TSX indices have increased by 3.6% during the month and the MSCI World ex. U.S. index has improved by 1.3%. The MSCI Emerging Markets Index underperformed, registering a minor 0.1% loss. Both government and corporate bond indices registered gains of 0.3% and 0.7% respectively. Because of our decision to overweight equities last month, and specifically U.S. equities, our overall allocation resulted in a 0.2% over performance relative to our benchmark. And so far in December, the positive momentum in equity markets continued due to the robust U.S. job creation observed in the later stages of 2019.

Strategically Careful but Tactically Optimistic

In addition to becoming increasingly unpredictable, trade frictions have become key drivers for the markets and the 2020 economic outlook. At the beginning of December, Trump mentioned during the NATO summit in London that he could wait until after the 2019 presidential election to reach a trade deal with China. Even if a so-called “Phase 1” trade deal is not reached by December 15th, 15% levies could be imposed on $160 billion of U.S. imports from China such as consumer goods including cellphones, laptops, toys and clothing. Since previous U.S. tariffs were mainly imposed on investment goods, directly taxing consumer goods could have a larger negative effect on U.S. economic growth and stoke CPI inflation on top of further depressing business investment spending and international trade activity. As it remains unclear if an imminent easing in trade tensions is in the cards, we remain cautious from a strategic standpoint.

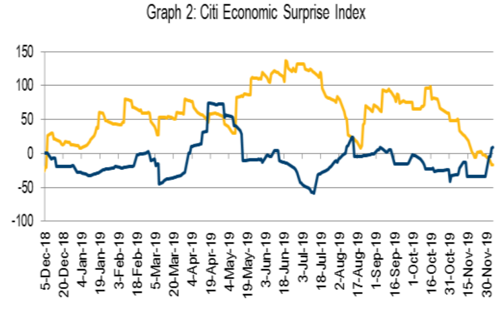
From a tactical point of view, we do not believe that the upcoming weeks will bring a steep downturn. First, the probability of a “no deal” between the U.S. and China is already partially priced in by market participants. Second, according to the U.S. National Retail Federation, many retailers pre-bought inventory for their stores last year ahead of scheduled tariff increases. As a result, most U.S. consumers might not see price increases passed onto them this holiday season. On the global front, we notice some improvement with a more resilient global growth and renewed U.S.-China trade talk optimism. The J.P. Morgan Global Composite PMI, which stood at 51.5, a 4-month high, shows that the global economy has expanded in both the manufacturing and service sectors (graph 1). The recovery was widespread with five out of six sub-sectors witnessing an increase in November. Only the international trade PMI component still shows a contraction, at 49. Another indicator showing signs of improvement during the last three months is the Global ZEW, an average of the Eurozone, UK, Japan and US economic business conditions. As a result of the above, we decided to keep our tactical asset allocation unchanged for the month of December by slightly overweighting equities.

Graph 1: Both Manufacturing and Services Expand



*50 = no change.
Source: J.P. Morgan Global Composite PMI/IHS Markit & Refinitiv Datastream

Graph 2: Citi Economic Surprise Index



Note: Daily Index, last observation on December 5 2019
Sources: Citi Economic Surprise Index/Citigroup/Bloomberg Finance L.P.

No Change in Our Country and Sector Allocation

There is no change to our regional allocation this month as we still favor U.S. equities over the rest of the world. As mentioned in last month's report, the U.S. consumer is expected to keep spending at a healthy pace. The U.S. Michigan Consumer Sentiment figure for November stood at 96.8, the highest reading since July 2019. Also, some of our short-term indicators still recommend a higher allocation to U.S. equities. The difference between the OECD Composite Leading Indicator for the U.S. versus the Euro Zone is displaying a positive momentum for the first time since last March and the U.S. Dollar Index DXY is showing a stronger price momentum.

On the Canadian front, on one hand, stocks have witnessed renewed optimism during the month of November on the back of eased trade tensions and thus a higher crude oil price. The S&P TSX had its best month since January of this year and reached a new record high. Also, at its latest meeting in early December, OPEC and its allies decided to deepen oil production cuts to 2.1M bpd from 1.2M bpd until at least the next meeting in March 2020. This aims to avert global oversupply caused by the increase in U.S. shale production and a softening in global demand. On the other hand, the Canadian energy sector continues to struggle because of constrained transportation capacities. Moreover, the Canadian Citi Economic Surprise Index is trending lower and reached its lowest level since July 2018 (graph 2). The most recent jobs, housing starts and trade reports all missed economists' expectations. We therefore remain cautious and decide to stay neutral relative to the benchmark.

Finally, we keep the same allocation as last month to emerging markets. They are favored by stronger earnings revisions and improving momentum in the price of copper. Economic growth in this area will most likely continue to be supported by expansionary policies as more central banks proceeded with rate cuts in November. In India, the corporate tax cuts announced which supplement the central bank's accommodative monetary policy, is likely to boost after-tax earnings and business investment. In China, economic momentum has been exceeding economists' expectations (graph 2). For example the Caixin Manufacturing PMI came at 51.8 in November versus a consensus of 51.4. This signals a modest improvement in China's manufacturing sector.

From a sectoral perspective, in the U.S. and in Canada, we continue to favor the **consumer staples**, **consumer discretionary, info tech**, **financials, utilities** and **telecom**. We choose the **healthcare** sector in the U.S. but not in Canada.

On the credit side, few indicators suggest increasing our allocation to corporate versus government bonds in Canada. For example, the Yardeni Boom-Bust Barometer, consisting of a raw industrial price index divided by initial unemployment claims, has increased; however it still stands at below its 3 year average. Thus, we think that it is better to avoid the downside risk that would cause widening credit spreads in return for only limited and temporary rewards. We therefore keep a 70/30 allocation to government and corporate bonds respectively, in line with our benchmark.

Recommended Portfolio as of December 2019				
Asset Classes & Regions	Recommended Weightings (%)	Benchmark Allocation (%)	Over/Underweights (%)	Recommendation
Bonds	45 (45)	50.0	-5.0	-
Government	31 (31)	34.4	-3.4	-
Corporate	14 (14)	15.6	-1.6	-
Equities	55 (55)	50.0	5.0	+
Canada	20 (20)	20.0	0.0	=
United States	20 (20)	16.0	4.0	+
Other Developed Markets	11.6 (11.6)	11.6	0.0	=
Emerging Markets	3.4 (3.4)	2.4	1.0	+

Note: Numbers in brackets represent previous month allocation.

Source: LBS Economic Research and Strategy.

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