Asset Allocation Model – June Update

Global risk assets continued to move higher in May, with world stocks reaching new all-time highs and corporate spreads continuing to tighten, despite a brief episode of rising market volatility due to increasing U.S. political uncertainty in mid-month. Accelerating earnings growth, the continued pick-up in global net earnings revisions, still strong business sentiment surveys and improving risk sentiment all continue to support risk asset prices. For example, with the Q1 earnings season largely over, reported earnings came in strong in Japan, Europe and the U.S. with each region delivering double-digit growth on a year-over-year basis. Rising U.S. industrial production growth and the continued pick-up in the year-over-year percent change in the Composite index of Coincident Indicators and the annualized six-month change in the Leading Economic Index all support the case for a continuation of the earnings acceleration phase that started in mid-2016. As mentioned in previous publications, accelerating earnings growth historically tends to coincide with rising equity prices.

However, we still remain comfortable with our decision to adopt a neutral stance on equity vs. fixed income at the end of January as many sentiment indicators and investor surveys continue to show historically high complacency and extreme optimism in the economic outlook, despite elevated political uncertainty. Another concern is that a coming deceleration in earnings momentum could well be reached in the next coming months, which could lead to equity weakness at some point. This is a key element to consider for investors as past turning points in the earnings cycle historically preceded shakeouts in reflation assets, as market participants turned too confident in their growth outlook. In addition to that, a coming moderation in economic momentum could make equities highly vulnerable to disappointment and the recent decline in steel scrap prices and the underperformance of base against precious metal prices may already point to such moderation. Moreover, some key indicators are flashing warnings signs with capital market and weak balance sheet stocks underperforming. We are therefore continuing to favor a defensive investment strategy this month.

Regional Allocation and Sector Rotation

There is no change to our regional allocation this month with our largest overweight remaining Canadian equities as we expect the global oil market to tighten in the coming quarters due to the combination of supply cuts by OPEC and non-OPEC producers and rising global demand, which should exert a positive influence on oil prices. As for our sector allocation in Canada, we still recommend to overweight the Energy, Materials, Telecommunication Services, Industrials and Information Technology sectors. In the U.S., we still advise clients to overweight the Energy, Materials, Information Technology, Telecommunication Services, Real Estate and Consumer Staples sectors.

Canadian Bond Allocation

Since we turned overweight corporate bonds against Canadian government back in April 2016, credit spreads have significantly tightened. If history is any guide, the ongoing earnings acceleration could still have fuel left in the tank, which should be supportive of credit. However, we remain concerned that a tipping point in earnings momentum might well be reached during the second half of 2017, which could then lead the current rally in credit to take a pause. Another concern is the recent decline in market-based inflation expectations and real money supply growth, which could point to an imminent moderation in economic momentum and a coming widening in credit spreads. The current underperformance of transportation and small-cap stocks may also point to a coming moderation in economic momentum. We remain overweight credit for now as the macroeconomic backdrop remains strong with initial jobless claims close to their lowest level since 1973 and the global net earnings revisions ratio close to a new high in more than six years. Under such conditions, we still see room for further spread compression although already tight spreads limit the room for a significant rally.

Model Portfolio as of June 2017				
Asset Classes & Regions	Recommended Weightings (%)	Benchmark Allocation (%)	Over/Underweights (%)	Recommendation
Bonds	50.0	50.0	0.0	=
Government	30.0	34.2	-4.2	-
Corporate	20.0	15.8	4.2	+
Equities	50.0	50.0	0.0	=
Canada	22.5	20.0	2.5	+
United States	15.0	16.0	-1.0	-
Other Developed Markets	9.6	11.6	-2.0	-
Emerging Markets	2.9	2.4	0.5	= / +

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