## Tactical Asset Allocation – Some options while waiting for more clarity (Jan. 2019 Update)

In our 2019 outlook published last week, one of the market calls over which we had the most conviction was that strong volatility would persist in the first half of the year. While not a very bold call to make, sharp movements in financial markets over the last week certainly continued. To illustrate this point, in 2017, the average gap between the high and the low of an S&P 500 daily trading session was a meagre 0.5%. In 2018, it had more than doubled; to 1.2%. And, with only three trading sessions behind us, the 2019 average is 2.2% (see table).

Investors seem to react strongly to economic news as it is still unclear the extent to which what we are witnessing is a mild economic slowdown or, as some are arguing, the start of a full blown recession. Since the outlook is still blurry, any economic data that confirms negative biases (last week's weak global PMIs, the contraction in China's Manufacturing PMI) or contradicts them (last Friday's strong U.S. employment report) causes wild market swings. We expect this environment to persist this month and, unless more evidence of a severe global slowdown appears soon, we do not, at this point, recommend a complete defensive overhaul of one's financial portfolio.

Moreover, with political tensions still very high between the United States and China and, as such, the real possibility of additional tariffs on Chinese imports to the U.S., we believe that keeping an overweight position towards U.S. stocks with a bias towards corporations more exposed to the domestic economy, will provide a hedge against an escalation of the current trade spat. Indeed, neither emerging markets, nor globally exposed European stocks would be immune if higher tariffs on Chinese goods be enacted by the Trump administration. Hence, we continue to carry very low exposure to emerging markets as well as other developed markets (see Table 3 for a breakdown of our tactical asset allocation).

**Table 1: Average S&P 500 Absolute % Change Between Daily Session High and Low**

| | |
|---|---|
| 2017 | 0.5 |
| 2018 | 1.2 |
| 2019 YTD | **2.2** |

Source: Thomson Reuters and LBS Econ. Res. And Strategy.

**Neutral in asset classes but shortening duration**

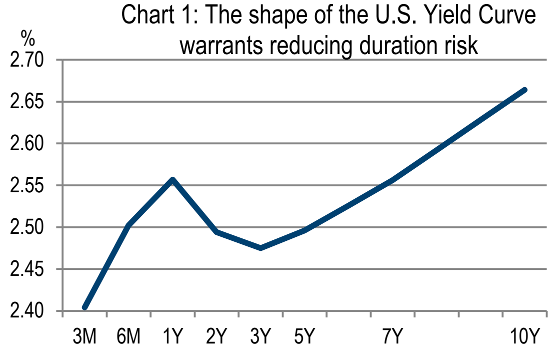
After the important December selloff in equities, some price momentum indicators switched to favouring a long bonds and short equities tactical positioning. Nonetheless, overall, our tactical asset allocation model still recommends keeping a neutral stance on equities versus bonds in January. High-frequency indicators, such as U.S. initial jobless claims and the OECD leading economic indicator for the U.S., still demonstrate positive momentum. Moreover, since October, the S&P 500 index is below its fair value implied by crude oil prices, forward earnings-per-share (EPS), the U.S. dollar index and bond yields, which makes equities attractive on a valuation basis.

Our 50% bond allocation is still heavily tilted, (38%) towards safer government bonds with an underweight exposure to corporate bonds (12%). High yield credit spreads have widened by a staggering 220 basis points since the end of September as mounting concerns over the level and, more importantly, the quality, of corporate credit have been the subject of financial market worries.[1]

However, in addition to maintaining our overweight government bond allocation, we now recommend investors to shorten the duration of their fixed income portfolio. Indeed, the current shape of the yield curve in the U.S., with its 3Y-2Y spread inverted, the 5Y-2Y virtually flat, and only 17 basis points spread in the 10Y-2Y segment of the yield curve, leaves, in our view, absolutely no room for further decline in interest rates at the long-end of the curve (see chart 1).

On the contrary, within the next month, with global central banks poised to turn more dovish as economic uncertainty increases, increasing one's exposure to the front end of the curve would be an opportunity to profit if, for example, the yield curve were to steepen because of both a decline in the 2Y yield and, potentially, further down the road, an increase in 10Y yield.[2] However, if the economic outlook were to deteriorate significantly in the near future, the yield curve could invert briefly in the 10Y-2Y segment. However, we do not believe that this scenario has a high probability, especially in the very near future, nor that betting on the inversion scenario would offer attractive returns.

Chart 1: The shape of the U.S. Yield Curve warrants reducing duration risk



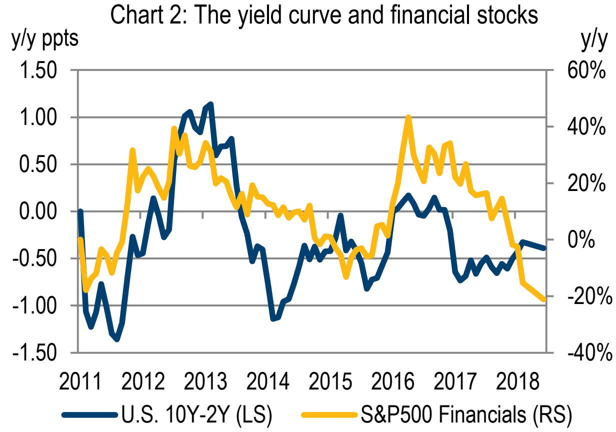

Note: Data is interpolated. As of January 4, 2019.

[1] Please see our 2019 outlook for more details on the issue of U.S. corporate debt.
[2] One property of the yield curve is that prices for bonds with longer maturity and higher duration are more sensitive to changes in interest rates than shorter duration ones.

**Building a more defensive strategy through sector picks**

As worries about economic growth and geopolitical tensions mounted in the last three months, cyclical stocks were hit harder than defensive ones. Therefore, a less negative price momentum in defensive sectors combined with positive forward EPS growth and a rising U.S. dollar leads us to recommend overweighting **utilities**, **health care** and **consumer staples** companies in the **U.S**. and **consumer staples**, and **telecommunication services** in **Canada**. Moreover, for both Canada and the U.S., we still favour financials as their valuations appear to already be pricing an inverted yield curve (see chart 2); still an unlikely a scenario in our view.

Chart 2: The yield curve and financial stocks




Sources: Bloomberg Finance L.P. and LBS Econ. Res. and Strategy.

Finally, our model recommends overweighting the information technology (IT) sector in Canada. While generating much less attention than its American counterparts, sometimes for good reason, the Canadian IT sector includes several software companies that are poised to benefit from an easing in geopolitical tensions. And, their current valuation is only slightly more expensive than the broad index. Considering their forward EPS estimates and growth potential, they are, again in our view, attractive assets (see Table 2).

| Table 2: TSX Valuations | Trailing P/E | 12-M Forward P/E | Valuation improvement |
|---|---|---|---|
| S&P TSX Capped | 20.9 | 15.2 | 5.6 |
| Consumer Staples | 17.1 | 15.5 | 1.6 |
| Energy | 13.4 | 10.6 | 2.8 |
| Financials | 10.8 | 9.5 | 1.3 |
| Health Care | - | 15.4 | - |
| Consumer Discretionary | 11.9 | 10.3 | 1.6 |
| Industrials | 15.4 | 15.0 | 0.4 |
| Information Technology | 32.1 | 20.9 | 11.2 |
| Materials | 14.8 | 16.7 | -1.9 |
| Utilities | 25.4 | 17.0 | 8.4 |

Note: As of January 4th, 2019.
Source: Thomson Reuters.

Table 3: Model Portfolio as of January 2019

| Asset Classes & Regions | Recommended Weightings (%) | Benchmark Allocation (%) | Over/Underweights (%) | Recommendation |
|---|---|---|---|---|
| Bonds | 50.0 | 50.0 | 0.0 | = |
| Government | 38.0 | 34.4 | 3.6 | + |
| Corporate | 12.0 | 15.6 | -3.6 | - |
| Equities | 50.0 | 50.0 | 0.0 | = |
| Canada | 20.0 | 20.0 | 0.0 | = |
| United States | 20.0 | 16.0 | 4.0 | + |
| Other Developed Markets | 7.6 | 11.6 | -4.0 | - |
| Emerging Markets | 2.4 | 2.4 | 0.0 | = |

**Luc Vallée** | Chief Strategist
514 350-3000 | valleel@vmbl.ca

**Dominique Lapointe** | Economist
514 350-2924 | lapointed@vmbl.ca