Asset Allocation Model – January Update

Global equities hit another record high in December as global economic data remained robust, economic growth prospects kept being upgraded and financial conditions stayed accommodative. In the U.S., in particular, the Republican tax reform has been perceived as a positive for earnings growth. We are still positive on financial market prospects and still recommend clients to play the growth trade as the global economic expansion remains in a synchronized upswing, characterized by above-trend growth and robust business investment and consumer spending. Risk of a near-term recession also remains historically low at this time and equity market valuations remain reasonable when compared to other asset classes such as government and corporate bonds. However, rather than overweighting equities as our favored instrument to do so, we continue to prefer playing the growth trade through our regional and sector allocation. Hence, we remain comfortable with our neutral stance on equities against bonds at this time, considering stocks' remarkably long winning streak, economic surprise indices hovering around historical highs and earnings growth likely to peak in the first half of 2018. We also remain concerned that a growing headwind for equities over the coming months will be the combination of accelerating inflation data and more restrictive monetary policies. The closing of output gap in the U.S. for the first time since the Great Recession and expectations that the output gap in Europe will also close during 2018 should exert upward pressure on inflation. Rising inflationary pressures should in turn lead to a growing shift in central bank monetary policy globally, which could ultimately weigh on stocks' price-to-earnings multiples. Retail investors are also showing high optimism with cash levels at exceptionally low levels, Indeed, Charles Schwab client cash balance as a percentage of total assets is currently at the lowest level in more than 25 years. This, historically, proved to be a good contrarian indicator.

Regional & Sector Allocation

There is no change 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 crude oil prices to rise in 2018. Macroeconomic conditions also remain ideal for emerging markets, with low real rates, soft inflation measures, easy financial conditions and improving global trade. EM central banks also have room to ease monetary policy as the EM-DM real yield differential remains historically wide and there is less need to defend the currencies. Forward earnings for emerging markets are also on the rise relative to developed markets, which represents another tailwind for EM equities. Moreover, emerging economies should fare well, benefiting from strengthening commodity prices.

As for our sector allocation in Canada, we still advise clients to overweight the Industrials, Financials, Information Technology and Energy sectors. We forecast WTI crude oil prices to reach $67 USD/bbl by year-end as excess global oil inventories should be eliminated by next Fall. Our expectations for falling inventories should benefit energy stocks. We are also adding Materials to our list of overweight sectors as the sector ranks first in our earnings momentum model, which historically coincided with sector outperformance.

In the U.S., we still recommend clients to overweight the Information Technology, Financials, Industrials, Materials and Energy sectors. Relative valuation for financials stocks appears attractive and 2018 expected earnings growth is elevated relative to other sectors. The Financials sector should also outperform in a rising rate scenario. In addition to that, business credit conditions remain favorable.

Canadian Bond Allocation

We maintain our neutral stance on corporate bonds this month as valuations is extremely rich and we are concerned that an increase in borrowing yields could hurt corporate fundamentals and the relative performance of credit. Upward pressure on inflation data could also negatively impact the profit margin outlook as margins historically tend to peak soon after output gaps close. Rising inflationary pressures should also lead to a growing shift in central bank monetary policy globally, which could lead to widening credit spreads as past declines in central bank net asset purchases coincided with widening spreads. On the other hand, still favorable financial conditions, rising earnings growth and low risk of a near-term recession should support the relative performance of credit by keeping defaults low in the near-term.

Model Portfolio as of January 2018				
Asset Classes & Regions	Recommended Weightings (%)	Benchmark Allocation (%)	Over/Underweights (%)	Recommendation
Bonds	50.0	50.0	0.0	=
Government	34.1	34.1	0.0	=
Corporate	15.9	15.9	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	12.0	11.6	0.4	= / +
Emerging Markets	4.0	2.4	1.6	+

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