Asset Allocation Model – April Update

Global economic data continued to beat expectations in March and still support the case for strong economic momentum and a continuation of the earnings acceleration phase that started in mid-2016. This positive backdrop is proving supportive for risk assets, as indicated by the strong correlation between macro surprises and world equities. However, economic surprise indices rarely stay as high for a long period of time as climbing expectations make economic numbers more difficult to beat wildly optimistic estimates. In other words, a coming moderation in economic momentum could make equities highly vulnerable to disappointment. The bad news is that a series of indicators are already pointing to a moderation in the weeks ahead, such as the recent deceleration in market-based inflation expectations, real money supply growth and steel scrap prices, as well as the underperformance of transportation and small-cap stocks. This is a key element to consider for investors as a moderation in economic momentum should result in a coming turnover in the already historically high ISM Manufacturing index, which historically preceded shakeouts in equities. As illustrated in the table below, U.S. and Canadian stocks recorded poor results in the three and six months following a peak in the ISM Manufacturing index. On average, the S&P 500 even suffered a maximum drawdown of 7.2% in the three months following a peak, despite the fact that the median maximum decline in the ISM over such a period was only 3.4 points. As a result, we 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 the lack of clarity and delays regarding Trump's tax policy platform. In light of the recent failure by Congress to repeal Obamacare, an attempt at extensive and controversial tax reforms by Republicans could be perceived negatively by market participants. Conversely, proposing bi-partisan tax cuts for the middle class would probably help sustain the current market rally and push up interest rates. Signs of extreme optimism include the recent increase in NYSE margin debt to a record high in February and the S&P 500 12-month forward PE-to-CBOE VIX ratio still standing at a new high since at least 1990. In addition to that, Citigroup's latest poll of pension, mutual and hedge fund investors showed that the median cash figure as a percent of assets under management remained at 3.5% in March, close to the lowest level seen over the past seven years.

S&P 500 Returns following Peaks in the ISM Manufacturing (Since 1960)

	3 Months Later				6 Months Later			
Peaks	Return	Max Drawdown	Minimum ISM over the following 3 months	Change in the ISM from the peak	Return	Max Drawdown	Minimum ISM over the following 6 months	Change in the ISM from the peak
December 1961	-2.8%	-5.1%	60.6	-3.6	-23.5%	-26.9%	50.8	-13.4
January 1966	-2.0%	-6.0%	64.2	-1.6	-10.0%	-10.0%	57.7	-8.1
November 1968	-9.4%	-9.6%	54.9	-3.2	-4.5%	-9.6%	54.9	-3.2
January 1973	-7.8%	-7.8%	67.7	-4.4	-6.7%	-12.7%	57.8	-14.3
July 1978	-7.5%	-7.5%	60.1	-2.1	-0.7%	-8.1%	58.5	-3.7
November 1980	-6.6%	-9.9%	48.8	-9.4	-5.6%	-9.9%	48.8	-9.4
December 1983	-3.5%	-6.4%	58.9	-11.0	-7.1%	-9.6%	58.1	-11.8
December 1987	4.8%	-1.8%	54.6	-6.4	10.7%	-1.8%	54.6	-6.4
October 1994	-0.4%	-5.7%	56.1	-3.3	9.0%	-5.7%	51.5	-7.9
July 1997	-4.2%	-8.1%	53.9	-3.8	2.7%	-8.1%	53.8	-3.9
November 1999	-1.6%	-4.0%	55.8	-2.3	2.3%	-4.0%	53.2	-4.9
June 2002	-17.6%	-19.4%	50.2	-3.4	-11.1%	-21.5%	48.5	-5.1
May 2004	-1.5%	-5.1%	58.5	-2.9	4.7%	-5.1%	56.2	-5.2
February 2011	1.4%	-5.3%	53.7	-6.3	-8.2%	-15.7%	52.3	-7.7
August 2014	3.2%	-7.0%	55.9	-2.0	5.0%	-7.0%	53.5	-4.4
Average	**-3.7%**	**-7.2%**	**56.9**	**-4.4**	**-2.9%**	**-10.4%**	**54.0**	**-7.3**
Median	**-2.8%**	**-6.4%**	**55.9**	**-3.4**	**-4.5%**	**-9.6%**	**53.8**	**-6.4**
# Down / Up	**12 / 3**				**9 / 6**			

S&P/TSX Composite Returns following Peaks in the ISM Manufacturing (Since 1960)

	3 Months Later	6 Months Later
Peaks	Return	Return
December 1961	-2.1%	-18.3%
January 1966	-2.9%	-8.2%
November 1968	-0.2%	8.6%
January 1973	-4.8%	-2.3%
July 1978	1.8%	13.5%
November 1980	-9.3%	-1.3%
December 1983	-6.7%	-13.0%
December 1987	4.9%	8.9%
October 1994	-6.4%	-0.3%
July 1997	-0.5%	-2.6%
November 1999	21.3%	23.0%
June 2002	-13.5%	-7.4%
May 2004	-0.5%	7.3%
February 2011	-2.4%	-9.7%
August 2014	-5.6%	-2.5%
Average	**-1.8%**	**-0.3%**
Median	**-2.4%**	**-2.3%**
# Down / Up	**12 / 3**	**10 / 5**

Source: LBS Economic Research & Strategy

Regional Allocation

In terms of regional allocation, our largest overweight remains Canadian equities as we expect the global oil market to tighten in the coming quarters due to supply cuts by OPEC and non-OPEC producers, which should exert a positive influence on oil prices. The price outlook also appears rosier with the recent liquidation of managed money net length in crude oil, which had previously reached historically high levels. We are also slightly reducing our Other Developed Markets equity underweight as earnings growth is accelerating relative to the U.S. and relative valuation appears attractive.

Sector Rotation

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 last recommended investors to overweight corporate bonds against Canadian government back in late April, credit spreads have significantly tightened. The ongoing earnings acceleration and strong economic backdrop should continue to be supportive of credit. However, without more clarity regarding Trump's tax policy platform, we remain concerned that a tipping point in earnings momentum might well be reached within the next three to six months, which could then lead the current rally in credit to take a pause. Another concern is the recent slowing pace of acceleration in market-based inflation expectations, which could point to a coming widening in credit spreads. We remain overweight credit for now as the macroeconomic backdrop remains strong with U.S. consumer confidence surging in March to its highest level since 2000 and global earnings revision still improving. 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 April 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	25.0	20.0	5.0	+
United States	14.0	16.0	-2.0	-
Other Developed Markets	8.6	11.6	-3.0	-
Emerging Markets	2.4	2.4	0.0	=

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