Tactical Asset Allocation (September Update): A Defensive Stance Is Still Suitable

- Further deterioration in the trade conflict and the U.S. Administration's posture regarding the trade war's negative effect on the economy lead us to believe that a trade deal with China by the end of 2019 is unlikely at this point;
- The increasing odds of a recession to 50% in 2020 support our slightly underweight position in equities relative to bonds;
- We continue to favour defensive sectors, adding the Canadian materials sector tilted towards gold mining companies. The precious metal should continue to move higher amidst risk aversion and low bond yields;
- A heavier corporate financing calendar in the month ahead, combined with the current risk-off environment, warrant a change from overweight to neutral for corporate bonds versus governmental bonds;

Recommended Portfolio as of September 2019				
Asset Classes & Regions	Recommended Weightings (%)	Benchmark Allocation (%)	Over/Underweights (%)	Recommendation
Bonds	55.0	50.0	5.0	+
Government	39.4 (34.4)	34.4	5.0	+
Corporate	15.6 (20.6)	15.6	0.0	=
Equities	45.0	50.0	-5.0	-
Canada	18.0	20.0	-2.0	-
United States	16.0	16.0	0.0	=
Other Developed Markets	9.6	11.6	-2.0	-
Emerging Markets	1.4	2.4	-1.0	-

Note: Numbers in bracket represent previous month allocation.
Source: LBS Economic Research and Strategy.

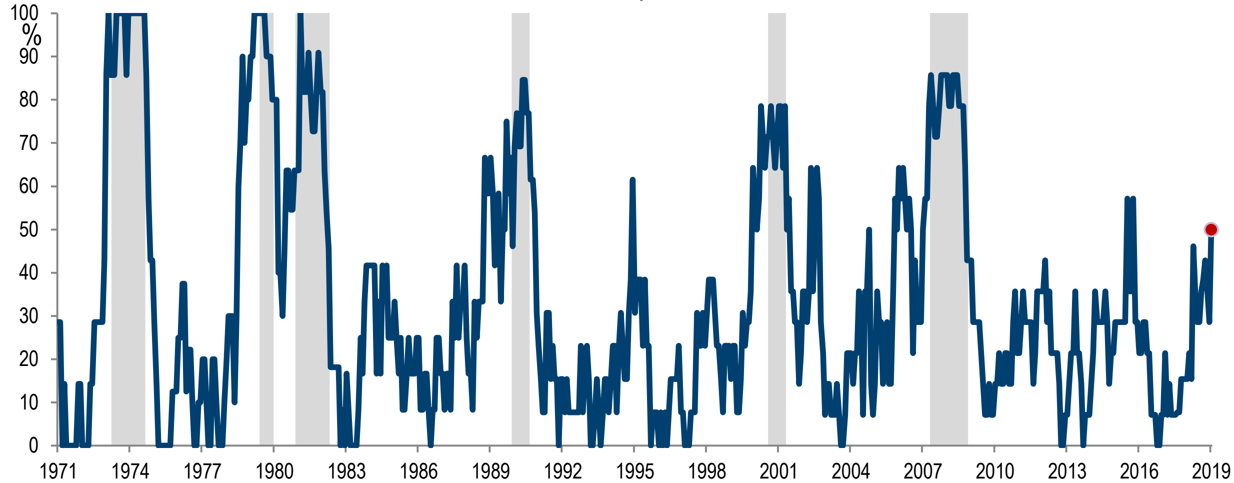
The trade war is getting worse again

A trade deal between the U.S. and China now seems less likely before the end of this year. First, during a media conference on August 20th at the White House, President Donald Trump reiterated his idea of trading short-term pain for long-term gain. Hence, the U.S. Administration is willing to pursue the hostilities despite the growing threat of a recession. Second, the Chinese position seems to have hardened given the imposition of retaliatory tariffs on US$75B of U.S. imports on August 23rd. It is less likely that the Chinese government will offer the necessary structural concessions necessary for a trade deal unless the U.S. changes its rhetoric. As of writing, the two sides agreed to pursue formal talks in October. This new round of trade talks brought back some hopes of real progress in financial markets. Nonetheless, back in August, both sides had also agreed to formerly talk in September before the Chinese retaliatory tariffs derailed the event. We are therefore skeptical that this short-term exuberance can persist.

The continued trade war escalation, increasing Brexit uncertainty and deteriorating economic conditions have prompted flight-to-safety in global markets during the month of August. The S&P 500 index lost 1.6%.The S&P TSX managed to increase by 0.4%, thanks to the performance of gold mining companies. In Fact, removing the 17% TSX gold index gain, the broad index declined by 0.6%. Our decision to remain defensive, underweighting equities in our model portfolio for a second consecutive month, proved timely.

For this month's recommendation, we also take into account the latest changes to our U.S. recession probability model. The odds of a recession within the next 6-to-12 months rose from a 30%-40% range to 50% for the first time since 2016. Also, the probability of a recession increased briefly in the 40%-45% range in late 2018 until the Fed saved the day in January 2019 by dropping its language that more rate hikes would be required. Today is different because markets are already pricing-in Fed rate cuts. Since we do not expect Germany or the U.S. to announce fiscal packages in the coming weeks, we continue to recommend an overweight position in bonds at 55% and a modest underweight position in equities at 45% (see table and chart 1).[1]

Chart 1 - LBS U.S. Recession Probability Model rises to 50% for the first time since 2016



Notes: Shaded areas represent NBER-designated recessions. The probability of a recession is over the next 6-12 months.
Sources: Bloomberg Finance L.P., Thomson Reuters and LBS Economic Research and Strategy.

From a sectoral perspective, the **utilities**, **consumer staples and telecommunication services** defensive sectors we recommended to overweight in August in both the U.S. and Canadian equity markets beat their respective benchmark. We also continue to recommend the **health care sector** in the U.S. but not in Canada. Also, we have recommended the TSX Information technology sector for the past year on the basis of a resilient U.S. consumer and the fact that Canadian IT companies are not subject to new taxes and restrictive legislation challenging U.S. big tech companies. While the sector eked out a 60% gain since the beginning of the year, we now see limited upside in the TSX IT sector due to elevated valuation and our expectation of further deterioration in market sentiment. Alternatively, as the price of gold kept grinding higher in 2019, so did Canadian gold mining companies. They have generated a 5% compounded monthly return (47% cumulative), with 13% compounded monthly return (43% cumulative total) in the past three months alone. Moreover, there is a strong correlation since 2015 between gold prices expressed in US$ and the appearance of negative-yielding bonds globally (chart 2). We tactically recommend investors to overweight the materials sector which include gold mining companies, or preferably to overweight the S&P TSX Gold Index alone. Given the growing signs of a recession and low odds of seeing an imminent and sustainable pullback in geopolitical risks, the growing search for liquid government bonds is more likely to imply more negative-yielding debt in the near future.

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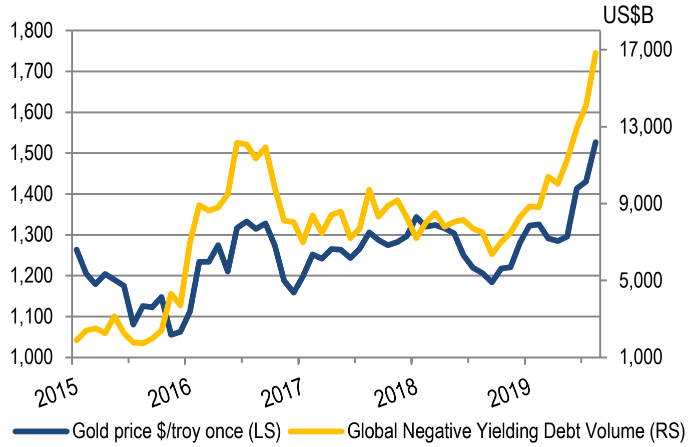
[1] The increase in recession probability from 29% at the end of July to 50% on September 4, 2019 was caused by the inversion of the 10Y-2Y U.S. Treasury curve, negative momentum in the Cass Freight Index measuring cargo volume shipments and negative economic growth implied by the ECRI weekly leading index.

Chart 2:Price of Gold and Global Negative Yielding Debt

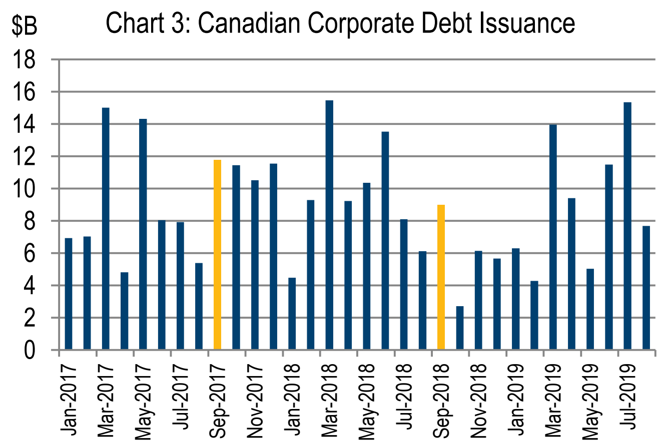


Source: Barclays/Bloomberg, LBS Economic Research and Strategy.

Returning to a more defensive bond allocation

August has seen Canadian and global bond yields fall further. On August 14th, Canada 10-year government bond yields fell to 1.10%, its lowest level since Trump got elected in November 2016 and only 13 basis points above its historical low reached on July 6th a week after the June 2016 Brexit vote. While both governmental and corporate bonds registered positive total returns last month, the very strong appetite for risk-free securities triggered by trade and Brexit uncertainty induced a government bonds over-performance, contrary to our expectations. For September, a projected loaded calendar for Canadian (and U.S.) corporate debt issuance lead us to think that corporate debt is now more vulnerable to a widening in spreads and therefore to a relative under-performance (chart 3). For these reasons, we roll-back our overweight position in corporate bonds and now adopt a neutral stance.

Chart 3: Canadian Corporate Debt Issuance



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