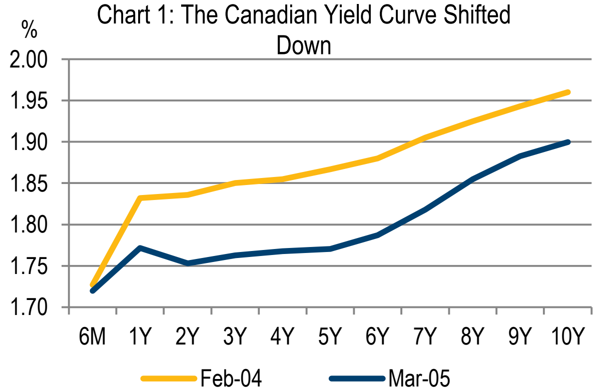
Laurentian Bank Securities
ECONOMIC RESEARCH AND STRATEGY

Tactical Asset Allocation – Waiting for a Chinese-driven global turnaround (March Update)

Our tactical decision to slightly overweight equities in early February returned a small profit as both the S&P/TSX and the S&P 500 indices increased by 3.0% during the month. Equity markets shrugged off constant downward revisions to bottom-up 2019H1 EPS growth estimates. For 2019Q1, according to Factset, S&P 500 EPS growth estimates have been revised down by 6.5%, the largest decline since 2016Q1, and are now expected to be negative. Moreover, as of last Friday, EPS growth projected by analysts was a tepid 0.3% for 2019Q2, close to a technical recession in earnings. The more concerning fact was the downward revision to profits observed across all industries.

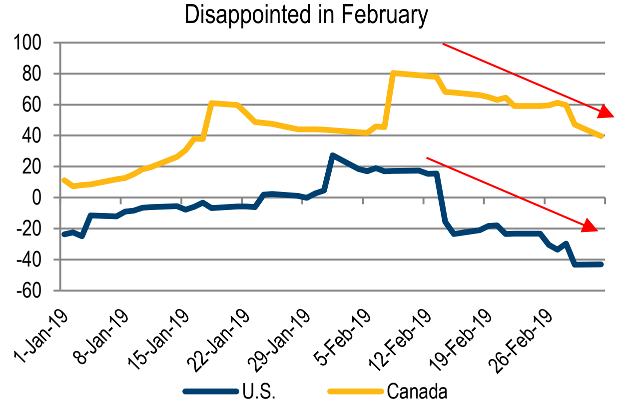
Month over month, Canadian bond indices registered minor gains in February as the yield curve shifted down on the back of disappointing Canadian and U.S. economic data (charts 1 and 2).

Chart 1: The Canadian Yield Curve Shifted Down



Note: Data is interpolated.
Sources: Bloomberg Finance L.P. and LBS Econ. Res. and Strategy.

Chart 2: Citi Economic Surprise Index Disappointed in February



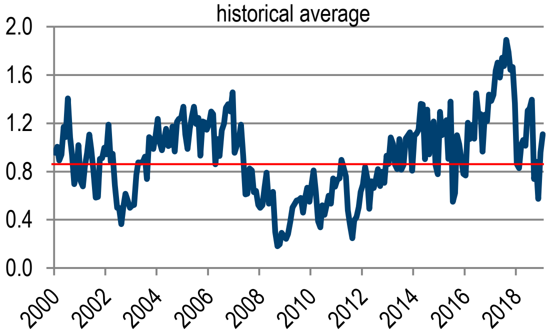
Note: Daily index.
Sources: Citi Economic Surprise Index/Citigroup/Bloomberg Finance L.P.

Trade uncertainty lingers

The trade war has been repeatedly targeted as one of the main driver of the 2018Q4 global equities selloff. But U.S.-China talks were constructive during the month of February. Notably, on February 21st, the U.S. President agreed to extend the deadline on 25% tariffs in order to reach a trade agreement with China. Since then, a deal appears within reach. The negotiations are now seemingly procedural, with a focus on how the U.S. can remove its existing 10% tariffs and ensure China's compliance with regular reviews. This being said, much uncertainty lingers about the fate of the Canada-US-Mexico-Agreement (CUSMA) and the investigation around the so-called "Section 232 of the Trade Expansion Act of 1962" *i.e.* on national security grounds. First, Mexico and Canada said that they could delay CUSMA's ratification until the U.S. drops its existing tariffs on steel and aluminum, which were imposed last year under Section 232. Even if they were dropped, the legislative process in Mexico would not allow ratification of the agreement before September 2019. At the same time, U.S. Democrats, who now control the House of Representatives, said they would not vote for the Agreement without substantial modification to the deal. On the other side of the Atlantic, unlike Mexico and Canada which will be exempted from Section 232 tariffs on motor vehicle and parts because of CUSMA, the European Union braces for the possibility of additional tariffs on their automotive exports to the U.S. Since the European Commission has already threatened to retaliate, trade fears could reignite in the weeks to come.

All in all, with no major equity rally on positive news regarding the U.S.-China trade conflict, considering the above-mentioned looming tensions, **we recommend to cut back on equities from slightly overweight to neutral for March (see table below).** While we acknowledge that some analysts see upside risks to equities if a U.S.-China trade deal is reached, some technical indicators are pointing towards prudence. First, at around 15, the CBOE Volatility Index (VIX) is close to the lows reached during the second and third quarters of 2018, suggesting market complacency (a contrarian indicator). Adding the increase in the forward P/E caused by both higher valuations and lower forward EPS, this measure of complacency recently returned slightly above its historical average (chart 3).

Chart 3: Forward P/E-to-VIX ratio back above historical average



Note: Red line denotes historical average.
Sources: Thomson Reuters, Bloomberg Finance L.P.,LBS Econ. Res. and Strategy.

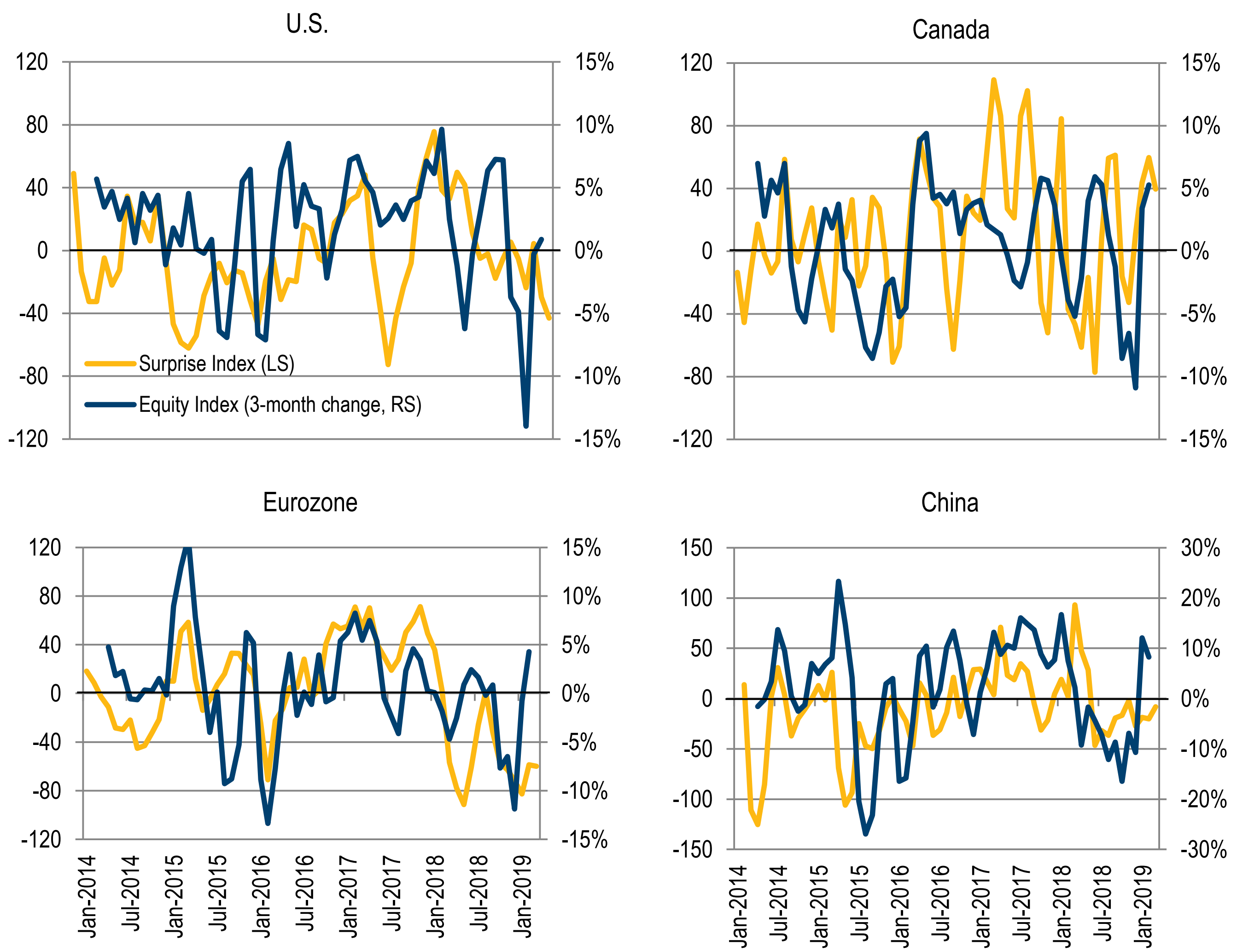
Overweight U.S. equities is still warranted

While Canadian equities have been slightly over-performing their American counterparts since the beginning of the year, Canadian economic data disappointed lately (e.g. last Friday's very weak GDP report). The Canadian economy could continue to stagnate in the months to come. A brief technical real GDP contraction is possible, which could reduce risk appetite. Thus, we believe that a moderate underweight position in Canadian equities is warranted for March, as negative economic surprises have often been correlated with equity underperformance across regions (chart 4). Conversely, the U.S. equity market still represents a good hedge against the negative ramifications of the trade war. Meanwhile, 2019Q1 GDP Nowcasts from the Atlanta Fed (+0.5% q/q annualized) and the New York Fed (+0.9%) have moved down closer to zero. But the momentum in U.S. consumer spending, the main driver of companies' revenues, remain in much better shape than GDP growth measures.

Sector wise, the U.S. and Canadian **financial sector** managed to eked out a 2.8% gain in February, in line with the TSX and the S&P 500 indices. Moreover, with the lowest 12-month forward P/E valuation ratio among all industries (11), we continue to recommend overweight exposure to the financial sector. For both the U.S. and Canada, we also continue to recommend the **information technology** sector, which outperformed since the beginning of the year.

Our defensive picks remain the **telecommunication** and **consumer staples** industries in Canada, particularly since household consumption slows down more than expected. In the U.S., we remain long **utilities and health care.** Also, we now recommend the **industrials** for both the U.S. and Canada as this sector is poised to benefit if an easing of trade tensions between the U.S. and China support the demand outlook for metals.

Chart 4: Equities performance and economic surprises



Notes: The Citigroup Economic Surprise Index (CESI) is a three-month weighted moving average that tracks economic performance relative to market expectations. The equity index is the S&P 500 (U.S.), S&P TSX (Canada), MSCI Local Currency (China), Euro STOXX 600 (Eurozone).
Source: Citi Economic Surprise Index/Citigroup/Bloomberg Finance L.P.

Can China revive global growth?

The Federal Reserve more dovish stance has clearly supported equities lately. Still, the global economic momentum continues to fade, pulled by the Chinese slowdown. However, the National People's Congress (China's legislature) annual session taking place this week has been the occasion for the Chinese government to introduce tax reforms. The objective is to ensure a soft lending in China and prevent a hard one. China sets its real GDP growth target in a new range of 6.0%-6.5% in 2019, below the 6.6% expansion of 2018. Additionally, China's total social financing (e.g. funds provided to the private sector economy) was up 51% from a year earlier in January (chart 5). All these stimulative policies from China, combined with a trade resolution with the U.S. could improve global GDP growth prospects for the second half of the year and beyond. With cooper prices trending up recently, our tactical asset allocation model now recommends a small overweight position in emerging markets in March. Finally, Chinese equities (which makes up 32% of the MSCI EM index), Japanese and European equities could benefit from an imminent trade deal between the U.S. and China.

Chart 5: China Total Social Financing Spikes Up

Source: PBOC via Thomson Reuters, LBS Econ. Res. and Strategy.

Keeping constant exposure to corporate bonds

While increasing our overall bond asset allocation to neutral, we leave our corporate bond allocation unchanged (slightly underweight relative to benchmark). Our model recognizes the positive narrowing in HY spreads. But in light of our wariness regarding low volatility and overall equity exposure, we believe that slightly overweighting government bonds is now appropriate in the short run.

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Recommended Portfolio as of March 2019				
Asset Classes & Regions	Recommended Weightings (%)	Benchmark Allocation (%)	Over/Underweights (%)	Recommendation
Bonds	50.0	50.0	0.0	=
Government	36.0	34.4	1.6	+
Corporate	14.0	15.6	-1.6	-
Equities	50.0	50.0	0.0	=
Canada	18.0	20.0	-2.0	-
United States	18.0	16.0	2.0	+
Other Developed Markets	10.7	11.6	-0.9	-
Emerging Markets	3.3	2.4	0.9	+