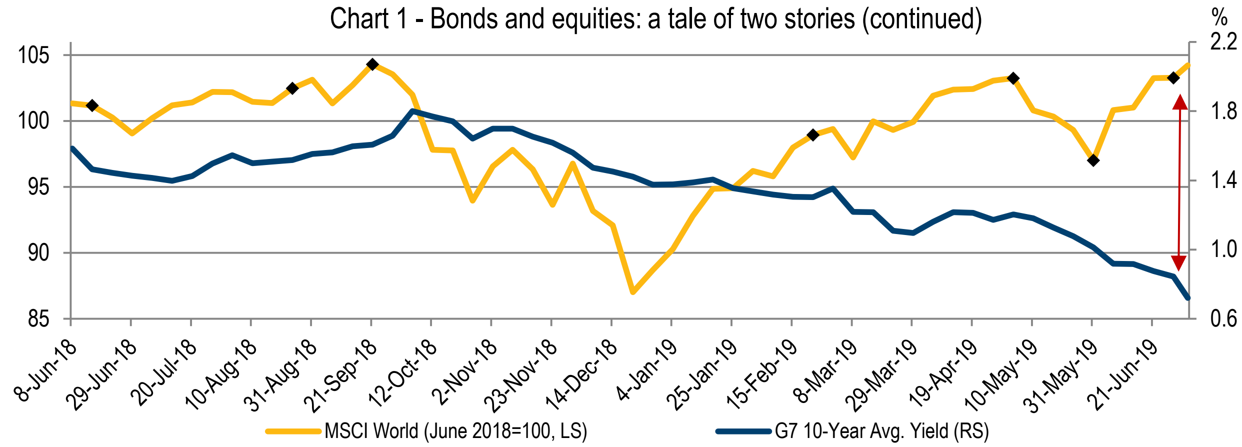
Tactical Asset Allocation (July Update) – Tactical Retreat

The tale of two stories continued in June. Bond markets kept rallying on the heels of fading economic momentum and reinforced expectation of central bank easing. Equities followed the ups and downs of the trade dispute (chart 1). Keeping an overweight position in stocks was profitable, especially in the U.S. equity market. The S&P 500 index gained an impressive 7.0%, over-performing the Canadian S&P TSX index (+2.5%) the MSCI World (Excluding U.S., +5.9%) and the MSCI emerging market index (+6.2%). At the same time, Canadian corporate bonds, towards which we have been recommending a neutral allocation since the beginning of this year (30% within the bond sector), over-performed government bonds, consistent with the positive momentum in equities.

Chart 1 - Bonds and equities: a tale of two stories (continued)



Notes: Trade war key dates: Aug. 23, 2018: 25% on US$16B Chinese imports; Sep. 24, 2018: 10% on US$200B; February 21 2019: U.S. announces China trade deal deadline extension; May 5 2019: Pres. Trump tweets 25% on US$200B and threatens 25% on remaining $US325B; May 31: U.S. announces 5% on all Mexican imports; June 28-29: G-20 Meeting / MSCI World does not include emerging markets.Last data point is July 3 2019.
Source: MSCI/Bloomberg Finance L.P.and LBS Economic Research and Strategy.

Unchanged strategic view but tactically cautious

Recent increases in equity prices were driven in part by the expectations of broad trade agreement between the U.S. and China. In fact, share prices of companies exposed to the Chinese market rose 15.1% since the end of May while the broad U.S. market index increased by 8.9%. We estimate that there could be a 14% potential gain to Chinese-exposed U.S. stocks relative to the entire universe of S&P500 companies if current tariffs are eventually reduced to zero (chart 2).

However, the disappointing outcome of the recent G-20 meeting between President Trump and Xi has pushed forward the resolution of the trade dispute and thus the materialization of the above-mentioned potential gains. It will also do nothing to dissipate the worrisome economic uncertainty stemming from trade tensions. While there was an agreement by the U.S. not to impose 25% tariffs on the remaining US$300B worth of Chinese goods currently not taxed, the meeting fell short of our expectations as both sides merely agreed to resume negotiating. Nevertheless, core issues related to intellectual property rights and foreign investment remain stale.[1]

[1] The details of the formal agreement between the two countries have not been published.

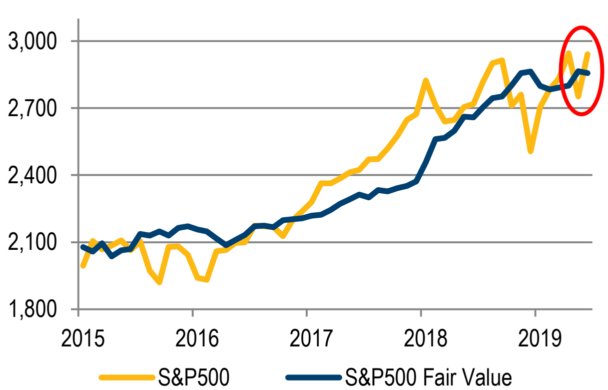
The permission granted to U.S. companies to resume selling technology equipment to Chinese telecom giant Huawei is positive and will certainly facilitate dialogue, but reports of pushback and pressure within the White House against that "concession" makes the issue unsettled at best. In light of this, for July, we recommend a tactical overweight position in bonds versus stocks (55/45). This shift from the June's 45/55 bonds vs. stocks allocation is based on the following factors:

Chart 2: China-exposed S&P 500 companies still lagging

Notes: Indexed Base: June 4th 2018. Individual stocks from Goldman Sachs. Last data point is July 3, 2019.
Source: Goldman Sachs, Bloomberg Finance L.P., LBS Econ. Res. & Strategy.

First, many equity markets reached or were close to all-time high levels in recent days. From a valuation perspective, the U.S. equity market was 2.9% above its estimated fair value at the end of June (chart 3). Moreover, at 1.2, the 12-month forward P/E-to-VIX ratio, a mean-reverting contrarian indicator stood above its historical average (0.9) after a blip under in May (chart 4). Hence, from a technical point of view, we see limited upside in the near-term.

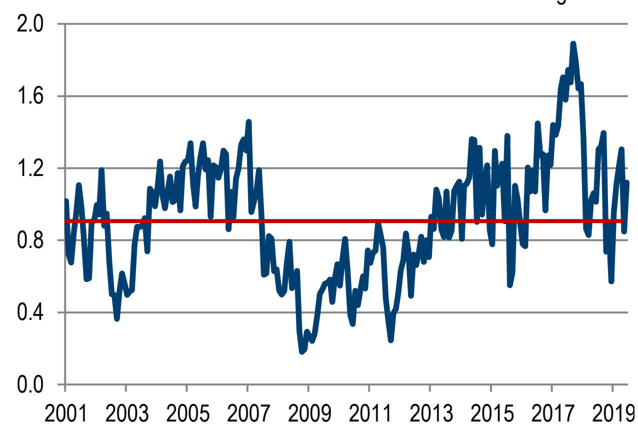
Chart 3 - U.S. Equities returned above fair value



Note: Fair value based on Treasury yields, crude oil prices and the trade-weighted U.S. dollar
Source: Thomson Reuters and LBS Econ. Res. and Strategy.

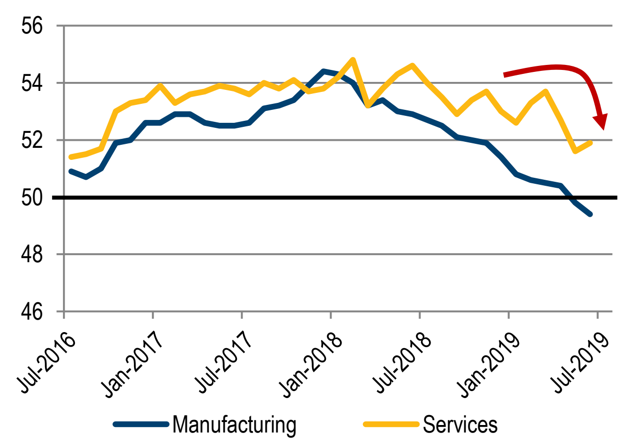
Second, from a fundamental perspective, the health of the global economy has continued to deteriorate last month. The Purchasing Manager Index (PMI), one of the earliest economic indicators to be published for June, signaled a contraction in manufacturing activity in 18 out of 30 countries. Again, the weakest components pertained to international trade (new orders and new exports) as trade uncertainty persisted. The ripple effects have now passed through to the output component, contracting at 49.5, down from 50.1 in May. Growth in services is also starting to slow down (chart 5).

Chart 4: Forward P/E-to-VIX above historical average



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

Chart 5: the slowdown in Global PMI continues



Sources: J.P. Morgan/IHS, Thomson Reuters Datastream.

So far, equity markets have shrugged off continued disappointing economic news, mostly out of the U.S. and China. The main reason behind this resilience is

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the assumption that central banks will ease monetary policy. This is 1) directly supporting equity valuation by lowering the discount rate used to value companies and 2) indirectly supporting profits by stimulating to some extent economic growth. Indeed, in its latest decision, the Federal Reserve signalled at the pivotal June 19th meeting its willingness to cut its policy rate as soon as its next meeting on July 31st.

This being said, financial markets expect much more. Up to four policy rate cuts over the next year are actually being reflected in interest rate futures prices (93 basis points). All *plausible* monetary easing expected by the end of this year has probably already been incorporated into financial asset prices unless a very severe recession unfolds in the months ahead. **Hence, there is now a distinct possibility that near-term weakness in economic data generates an exacerbated risk-off sentiment in financial markets.** One trigger could be the employment report for June in the U.S., to be released on Friday, July 5th. It could come short of expectations (+160K) as record-high global uncertainty further paralyzes and delays hiring. The second consecutive disappointing ADP employment report and the weak U.S. manufacturing PMI employment component for June reinforce this view. All things considered, while maintaining our rather positive strategical view on the economic situation and global risk assets, despite the reducing odds of such an outcome, we believe a moderate tactical retreat from equity exposure is warranted for July.

Geographically, our tactical allocation within equities is broadly unchanged from May. We continue to recommend 35% of the *equity allocation* to the U.S. Also, on the heels of a much stronger economic momentum in Canada relative to other developed markets and, for the first time in 14 months, a weaker momentum in the U.S. dollar, we slightly increased the *equity allocation* to Canadian stocks, from 36% to 40%. Finally, while we continue to strategically hold a bullish view on emerging market equities due to our call for a resolution of U.S.-China trade tensions, it is unlikely to happen in July. Thus, we recommend to tactically underweight emerging market equities.[2]

For both Canada and the U.S., we take a rather defensive stance, overweighting the **utilities**, **consumer staples** and **telecommunication services** sectors. In Canada, we also keep the **information technology** sector which has exhibited strong price momentum in the last few quarters. Finally, we add the defensive **health care** in the United States. Although our model would also recommend overweighting the Canadian healthcare sector, mainly compromised of cannabis stocks (6 out of 11), we believe chasing the rally in that sector is risky. Indeed, a large part of cannabis companies' strong performance year-to-date is based on market expectation that Canadian companies will eventually access the U.S. market which, according to many estimates, dwarfs the size of the Canadian market. This view incorporates major legal and regulatory risk and, since health care represents a mere 2.2% of the broader S&P TSX Index, we continue to underweight the sector.

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[2] Relative to the benchmark portfolio, since equities as an asset class are underweighted, all markets within the equity allocation are underweighted except the United States which is neutral (see table).

Recommended Portfolio as of July 2019				
Asset Classes & Regions	Recommended Weightings (%)	Benchmark Allocation (%)	Over/Underweights (%)	Recommendation
Bonds	55.0	50.0	5.0	+
Government	39.4	34.4	5.0	+
Corporate	15.6	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	-

Source: LBS Economic Research and Strategy.

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