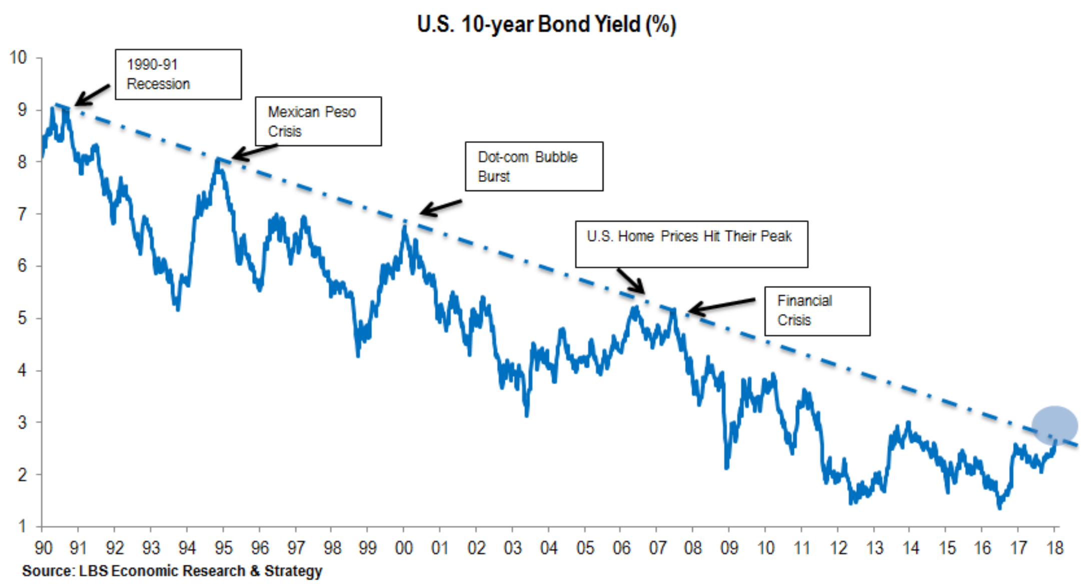
Asset Allocation Model – February Update

Robust and synchronized upswing in global economic growth, still accelerating earnings growth, global consensus earnings projections continuing to improve and accommodative financial conditions all remained supportive of equities in January. Even if we remain positive on financial market prospects and still recommend clients to play the growth trade through our regional and sector allocation, the increasing number of indicators illustrating extreme positivism and complacency in the market leads us to adopt a more cautious approach within our asset class allocation at this time. For example, high optimism among retail investors can be illustrated with Charles Schwab client cash balance as a percentage of total assets hovering at its lowest level in more than 25 years. This, historically, proved to be a good contrarian indicator. Also, the AAII Bull-Bear differential recently hit its highest level since the end of 2010, also illustrating the extreme positivism among individual investors. Stocks' remarkably long winning streak, economic surprise indices dipping from historical highs and the increasing number of indicators portraying a deterioration in economic momentum largely support our cautious approach on stocks at this time. 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 the output gap in the U.S. for the first time since the Great Recession, the increasingly positive Japanese output gap and rising 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. As a result, we are neutral on equities against bonds at this time.

We are also closely monitoring the recent sharp increase in borrowing yields considering the rapidly deteriorating credit metrics and the rising amount of debt in the financial system that makes global economic growth more sensitive to a tightening in financial conditions. In other words, a significant rise in interest rates that does not coincide with an improving economic backdrop could act as a choking point for global economic growth and hurt the profit margin outlook (see chart below). A source of concern is that the combination of the recent pick-up in real yields and weakness in the U.S. dollar could be driven, in part, by Chinese slowing purchases of U.S. Treasuries. If the rise in interest rates be sustained and eventually reach levels acting as a choking point for economic growth, this could hurt the relative performance of stocks. The good news is that the real economy appears to be digesting well higher rates so far with business indicators such as the ISM Manufacturing index still historically high, U.S. weekly jobless claims close to a 45-year low and the Mortgage Bankers Association's seasonally adjusted purchase applications index recently reaching its highest level since April 2010. The credit market also continues to send a positive message with spreads continuing to tighten. Investors should closely monitor coming developments in credit markets as a widening in corporate spreads often tends to lead market pullbacks or corrections.



Moreover, an important concern is that a coming deceleration in earnings momentum, which has not occurred yet, may lead to an equity correction at some point. This is a key element to consider for investors as past turning points in the earnings cycle historically preceded shakeouts in reflation assets, as market participants turned too confident in their growth outlook. For instance, when the U.S. earnings cycle last turned from an acceleration phase to a deceleration at the end of 2014, stocks sank while bonds rallied in the following months. Equities also underperformed bonds following similar earnings cycle transitions at the end of 2010 and in mid-2004. We have studied each periods of accelerating earnings growth seen over the last three decades in order to get a better understanding of how key macro indicators typically behaved when the business cycle transited from an acceleration phase to decelerating earnings growth. The table below illustrates our findings and how the current episode compares. The good news is that, if history is any guide, the ongoing earnings acceleration could still have fuel left in the tank, which should support equities in the near-term and suggest that a coming pullback might prove to be a good re-entry point. Indeed, growth in U.S. industrial production, forward profit margins and the annualized six-month change in the Leading Economic Index all remain within an uptrend, which is not typical of an imminent deceleration in earnings growth. Moreover, the implementation of the U.S. tax reform is a positive for earnings growth projections. However, we remain concerned that a tipping point in earnings momentum might well be reached during 2018, which could add significant market volatility.

	Lead Indicator Dashboard	Typical Behavior When EPS Growth Transits From An Acceleration Phase to Decelerating	Current
1	ISM Manufacturing	The index is historically high (above the 55 level) and showing signs of topping or is already on the decline	Index is historically high and showing signs of topping
2	U.S. Industrial Production	The %YOY change is topping or weakening	YOY change is still rising
3	% of Industries with Negative YOY Industrial Production Growth	The % of industry groups with negative YOY production is historically low or on the rebound	Indicator is historically low (under 25%)
4	Initial Jobless Claims	The %YOY change is on the rebound following a bottoming process	Indicator is not yet on the rebound
5	U.S. Leading Economic Indicator	The annualized 6-month rate of change is topping or on the decline	Indicator is on the rise
6	U.S. Coincident Economic Indicator	The %YOY change is topping or on the decline	Indicator is on the rise
7	U.S. Yield Curve (10-2s)	Yield curve is flattening	Yield curve is flattening
8	LBS Recession Model	Probabilities are the rise	Probabilities are increasing
9	S&P 500 12-month Forward Profit Margins	Signs of topping	Still rising

Source: LBS Economic Research & Strategy

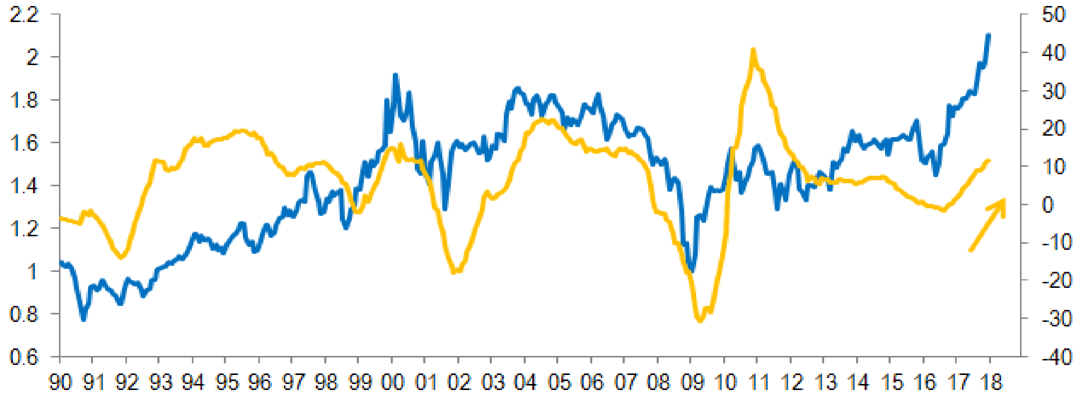
Regional Allocation

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 further in 2018 on the back of a tightening global oil market. Macroeconomic conditions also remain ideal for emerging markets, with persistent low real rates, soft inflation measures, easy financial conditions and improving global trade. Forward earnings for emerging markets are also accelerating relative to developed markets, which represent another tailwind for EM equities. Moreover, EM benefit from rising global high-tech capex spending as the information technology sector now accounts for close to 27% of EM market cap.

Sector Allocation

Our sector allocation is unchanged this month. We continue to recommend clients to play the risk-on trade through overweight positions in the **Information Technology**, **Industrials**, **Financials**, **Energy** and **Materials** sectors in both Canada and the U.S. Our expectations for earnings growth to continue accelerating and economic growth to remain robust in the near term, combined with still easy financial conditions and equity inflows continuing to improve largely support our call to still favor cyclical assets over defensive sectors at this time, despite elevated relative valuations (see chart below). Moreover, cyclicals' earnings relative to defensive sectors continue to accelerate, supporting the outperformance of cyclicals. Our expectations for accelerating inflation data should also contribute positively to the relative performance of the Energy and Materials sectors, which historically tended to outperform the broader market during episodes of higher inflation.

S&P 500 Cyclicals*-to-Defensive Sectors Ratio vs. S&P 500 Earnings Growth**

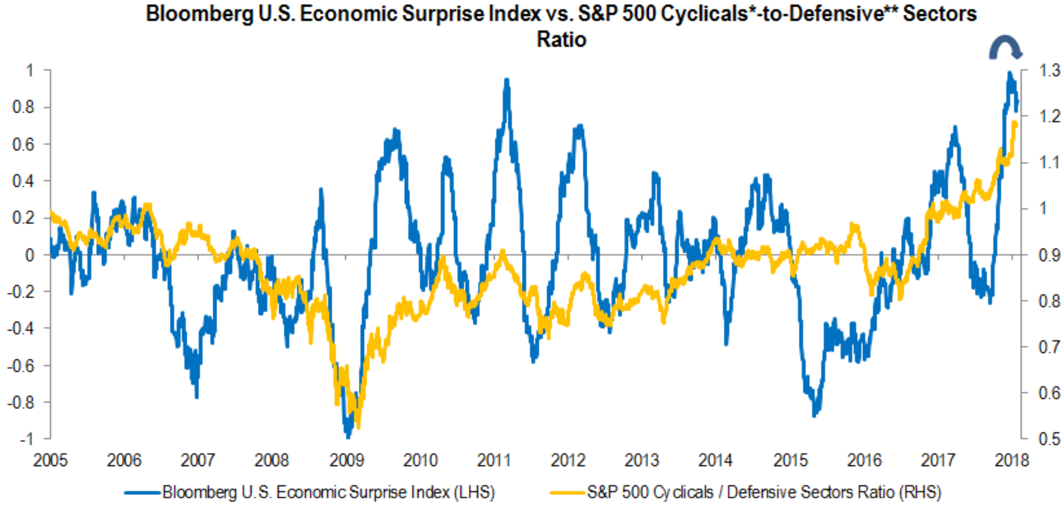


* Cyclicals are an equally-weighted index composed of the Consumer Discretionary, Financials, Information Technology and Industrials sectors
** Defensives are an equally-weighted index composed of the Consumer Staples, Health Care, Telecommunication Services and Utilities

Source: LBS Economic Research & Strategy, Bloomberg

On the other hand, sources of concern include the current shift lower in the IFO Business Expectations index and economic data surprise indices, albeit from historically high levels. Data remain strong but a potential moderation in economic momentum with more data releases missing increasingly optimistic economists' estimates may eventually weigh on the relative performance of cyclical over defensive sectors (see chart below). The recent sharp rise in interest rates represents another worrying signal. Should the tightening in financial conditions continue and rates eventually reach levels acting as a choking point for economic growth, this could hurt global economic prospects and the relative performance of cyclical sectors.

Bloomberg U.S. Economic Surprise Index vs. S&P 500 Cyclicals*-to-Defensive Sectors Ratio**



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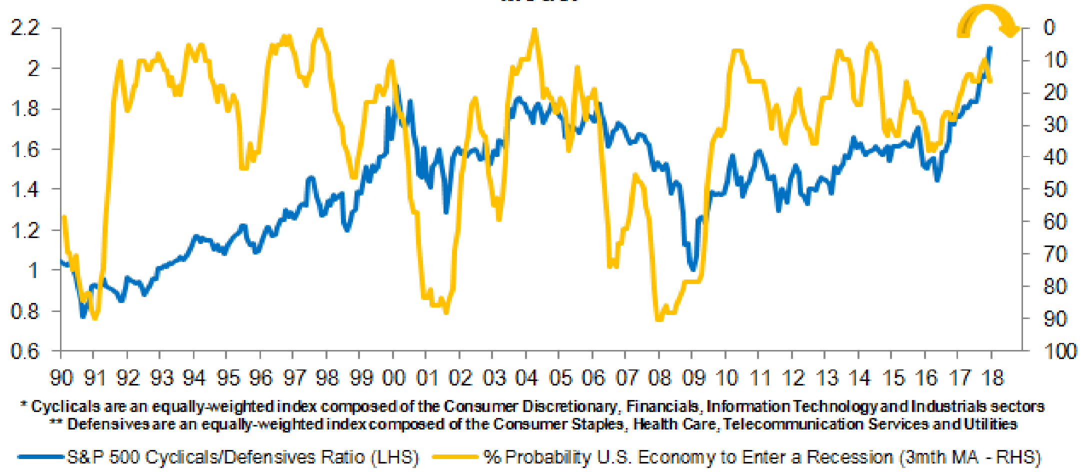
Source: LBS Economic Research & Strategy, Bloomberg

Moreover, according to our recession model, the risk of a near-term recession has recently increased, albeit from historically low levels. This is important as rising probabilities that the U.S. economy is about to enter a recession within the next six months have historically tended to coincide with an outperformance of defensive assets over cyclicals (see chart below). We will closely monitor future changes in the indicators mentioned above over the next few weeks to see if we should soon adopt a more defensive positioning within our sector allocation.

S&P 500 Cyclicals*-to-Defensive Sectors Ratio vs. LBS Recession Model**



Source: LBS Economic Research & Strategy, Bloomberg

Canadian Bond Allocation

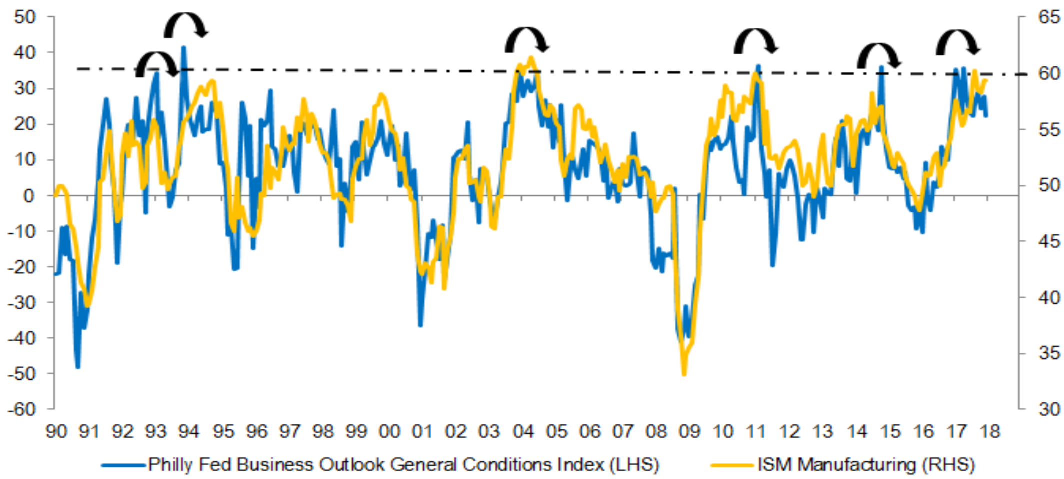
Strong economic data, higher government bond yields, still favorable financial conditions, the continued acceleration in earnings growth and the ongoing demand for yield globally all supported credit spread tightening in January. On the other hand, credit valuation has now turned very rich, especially when adjusted for elevated corporate leverage (see chart below). This clearly limits future return potential, in our view.

U.S. Nonfinancial Corporate Debt as a % of GDP

Source: LBS Economic Research & Strategy, Federal Reserve, FRB of St.Louis

The macro environment may also gradually become less favourable as wage inflation picks up, central banks continue to slowly normalize front-end interest rates and economic momentum starts to slow during the first half of 2018. Some indicators are already pointing to a deterioration in growth momentum with G10 data surprises indices turning lower and the Philadelphia Fed index sliding in January to a new low since August 2017 (see chart below). The composition of the Philly Fed report was also weak with the new orders component falling sharply (down 18.1 points month-over-month). In addition, the recent closing of the output gap in the U.S. for the first time since the Great Recession, the increasingly positive Japanese output gap and rising expectations that the output gap in Europe will close this year should add upward pressure on inflation and negatively impact the profit margin outlook as margins historically tend to peak soon after output gaps close. Downward pressures on profit margins should represent a headwind to credit. The current positive trend in the relative performance of copper against gold prices also goes in-line with rising inflation data ahead. Rising inflationary pressures should 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. Although we expect the new Fed Chair Jerome Powell to largely continue the monetary policy established by outgoing Chair Janet Yellen, there is still a risk that he may follow a more rapid pace of tightening than his predecessor in the face of accelerating inflation.

Philadelphia Fed Business Outlook Survey General Conditions Index vs. ISM Manufacturing



Source: LBS Economic Research & Strategy, Bloomberg

Despite these concerns, we are neutral on credit at this time as we still expect global economic growth to remain strong and financial conditions to stay accommodative. Also, according to our recession model, the risk of a near-term recession remains low, supporting the relative performance of credit by keeping defaults low. The historically low number of initial jobless claims, continuous rise in the Conference Board U.S. leading economic indicator and the positive evolution of cyclical components of the U.S. economy in relation to overall real economic growth all suggest a low level of recession risk. We will closely monitor changes in our recession model over the next few months to see how our investment recommendations need to be adjusted to take this into account.

Model Portfolio as of February 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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