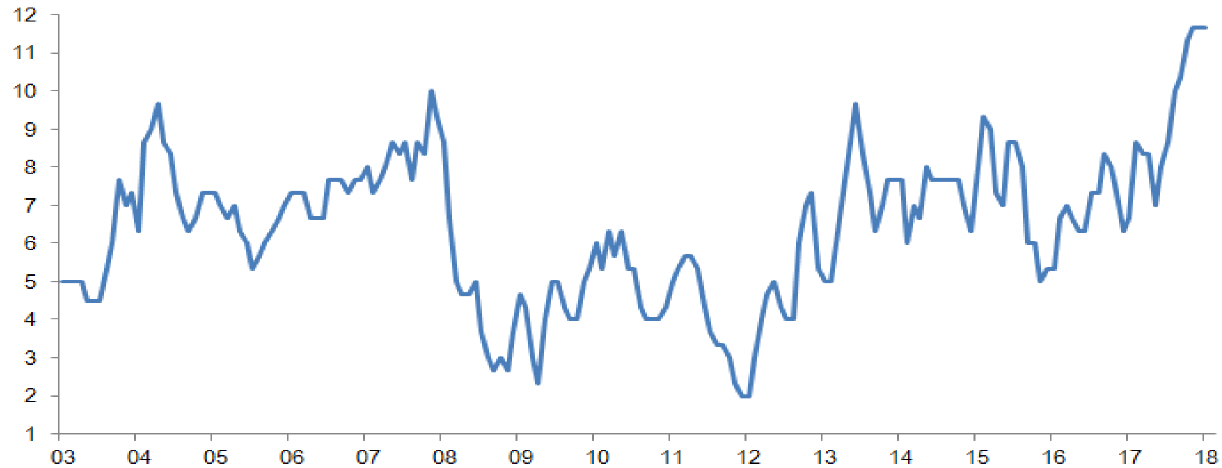
Asset Allocation Model – March Update

The month of February was marked by a sell-off in global equity markets and a sudden increase in market volatility with the CBOE Volatility Index reaching its highest level since August 2015. The rout in global equities appeared largely technical / positioning-driven, in our view, with global equities overdue for a pullback and most sentiment indicators we monitor hitting extreme levels of positivism and complacency in January. For instance, the S&P 500 index had not suffered a 5% pullback in 404 trading days, the longest streak in more than ninety years. Also, the percentage of respondents in the University of Michigan's survey of consumers viewing the probability of increase in stock market in the next year as ``100%`` hit a more than 15-year high in January (see the chart below). We also attribute the pullback in global equities to the recent sharp increase in long-term bond yields to key technical levels as investors increasingly feared that the rise in borrowing rates could act as a choking point for global economic growth.

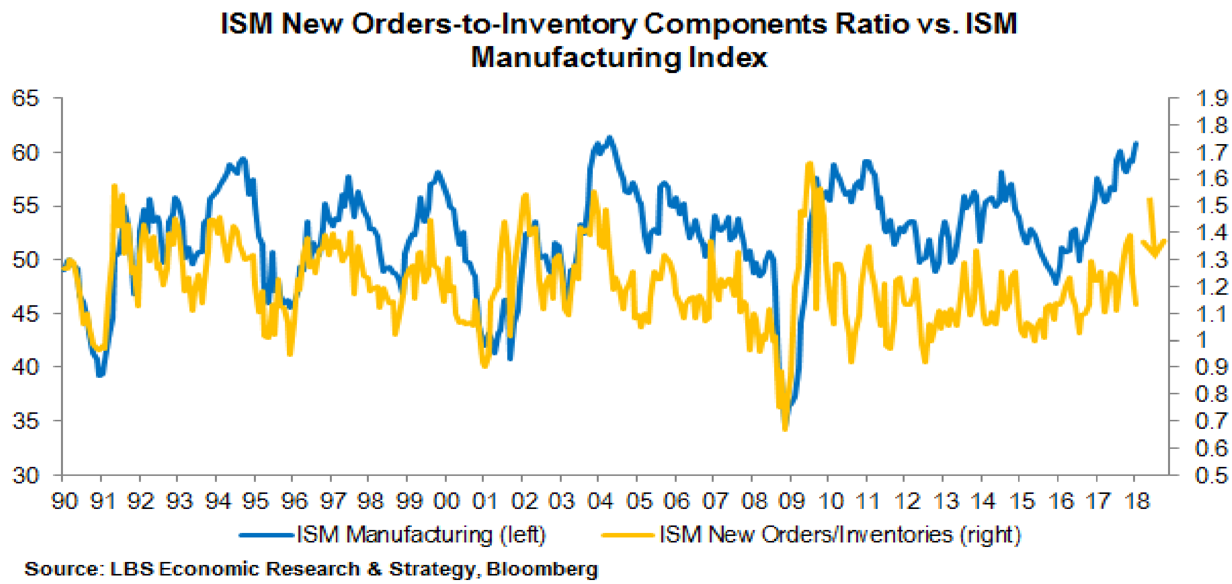
% of Respondents Answering There Is 100% Chance of An Increase in Stock Market in the Next Year (3-month moving average)



Source: LBS Economic Research & Strategy, University of Michigan Surveys of Consumers

The good news is that the macroeconomic backdrop remains solid despite the recent increase in borrowing yields, in our view. Business indicators such as the ISM Manufacturing index rising to a cycle high in February, initial jobless claims falling to the lowest level since 1969 and the Conference Board index of consumer confidence reaching a new cycle high in February all support the case for an economy that digests higher rates well so far. Emerging market equities also fared very well against developed markets during the global equity sell-off, also suggesting that the economic backdrop remains strong despite rising bond yields. The increase in market-based inflation expectations to new highs since September 2014 also goes in-line with robust economic growth.

On the other hand, the macro environment may 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. For instance, Germany's business climate declined considerably in February. The IFO Expectations Index, representing companies' assessments of the business outlook for the months ahead, fell to 105.4 points in February, a new low since April 2017. The large drop in the ISM New Orders-to-Inventory Components ratio in February to a new low since August 2017 also points to an imminent peak in the ISM Manufacturing index (see the chart below).



This is key to investors as previous rollovers in the ISM Manufacturing index 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.

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%	54.8	-4.4	-8.2%	-15.7%	52.6	-6.6
August 2014	3.2%	-7.0%	55.5	-2.7	5.0%	-7.0%	53.0	-5.2
Average	-3.7%	-7.2%	57.0	-4.3	-2.9%	-10.4%	54.0	-7.3
Median	-2.8%	-6.4%	55.8	-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

The turn lower in both the IFO Expectations Index and the ISM New Orders-to-Inventory Components ratio add to the growing list of indicators suggesting that growth momentum may be peaking and 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. As a result, we remain neutral on equities against bonds at this time.

Regional Allocation

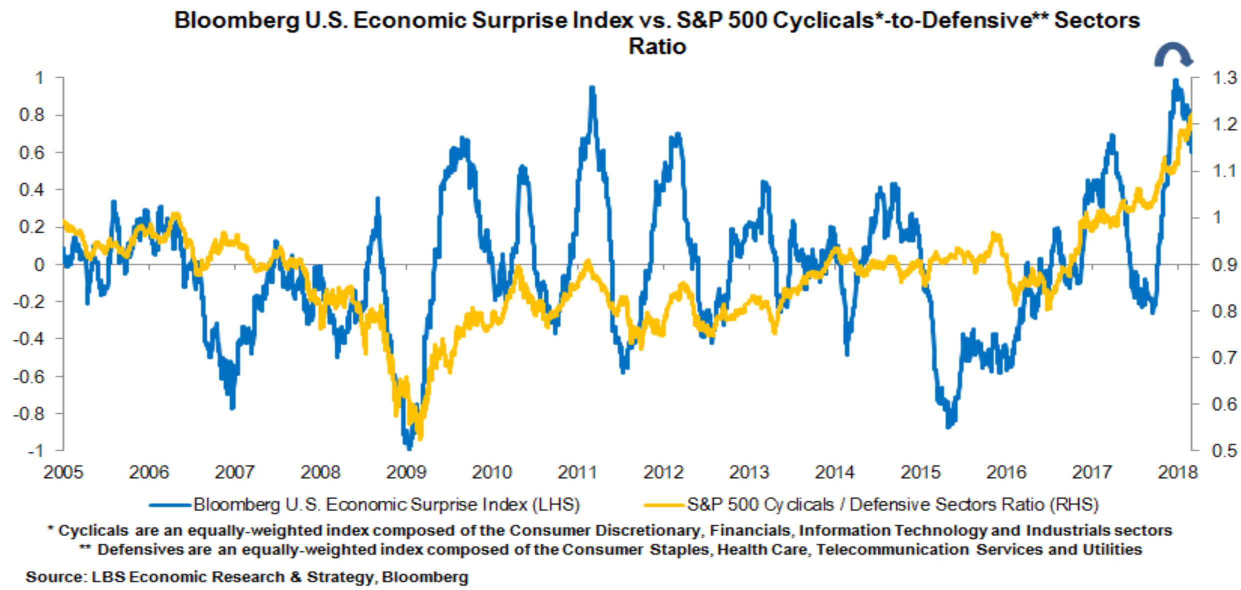
There is no change to our regional allocation this month with our largest overweight remaining Canadian and Emerging market equities. Canadian stocks remain historically cheap relative to U.S. equities and we continue to expect crude oil prices to rise further in 2018 on the back of a tightening global oil market. The combination of robust global economic growth, emerging market growth acceleration and high OPEC and Russia's compliance with their production cuts should keep the oil market tight this year.

Macroeconomic conditions also remain ideal for emerging markets, with persistent low real rates, 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. It is also worth noting that EM equities fared well relative to developed markets in the recent market sell-off, suggesting that the macroeconomic backdrop remains strong and supportive of EM. Central banks in emerging markets also have room to ease monetary policy as the EM-DM real yield differential remains historically wide and there is less need to defend the currencies.

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 largely support our call to still favor cyclical assets over defensive sectors at this time, despite elevated relative valuations. Moreover, cyclicals' earnings relative to defensive sectors continue to accelerate, supporting the outperformance of cyclicals. 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.

Simultaneously, the move higher in yields should continue to benefit cyclicals against defensive sectors as rising rates largely display strong economic growth and the global economy appears to digest higher yields well so far. Rising market-based inflation expectations also appear to confirm improving economic growth. On the other hand, if interest rates were to eventually reach levels acting as a choking point for economic growth or increase too quickly, this could hurt the relative performance of cyclical stocks. The recent weakness in U.S. and Canadian housing data could be a sign that higher rates may have finally started to negatively impact the real economy and we will closely monitor future developments in interest sensitive economic data to see if we should adopt a more defensive positioning within our sector allocation. In addition, the recent turn lower in economic data surprise indices should be monitored closely as this may portray economic momentum potentially peaking. 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).



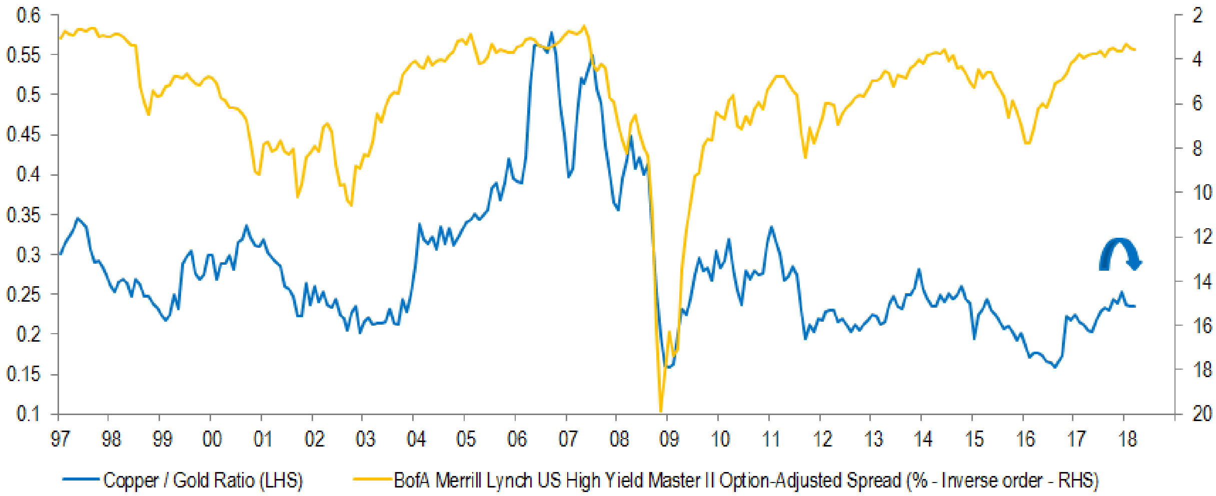
Canadian Bond Allocation

The credit market selloff in early February appeared largely technical / positioning-driven as the macroeconomic backdrop remains very solid despite the recent increase in rates. The ISM Manufacturing index rising to a cycle high in February, initial jobless claims falling to the lowest level since 1969 and real policy interest rates across the developed world still in negative territory should continue to support global growth prospects. In addition, according to our recession model, the risk of a near-term recession remains low, supporting the relative performance of credit by keeping defaults low.

We still maintain our neutral stance on corporate bonds as valuation remains historically rich, especially when adjusted for elevated corporate leverage. A coming deceleration in economic momentum, slowing earnings growth and central banks withdrawing stimulus could also hurt the relative performance of credit at some point this year. With 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, we should also expect upward pressure on inflation data, negatively impacting the profit margin outlook. Indeed, profit margins historically tend to peak soon after output gaps close, which should represent a headwind to credit.

Moreover, the copper-to-gold ratio represents an important barometer of global growth and historically tends to correlate well with credit spreads (see the chart below). Copper is an industrial metal with consumption increasing during periods of economic expansion, whereas gold is a precious metal and widely seen as a store of value. In other words, when the copper-to-gold ratio is rising, the macroeconomic backdrop typically tends to be positive, supporting the relative performance of credit. In contrast, when this ratio is declining, the economic environment historically tends to be deteriorating, acting as a headwind to credit. As illustrated below, copper prices appear to be topping against gold, suggesting that global economic momentum may be peaking and future return potential in the credit space now appears limited.

Copper / Gold Ratio vs. BofA Merril Lynch U.S. High-Yield Master II OAS



Source: LBS Economic Research & Strategy, Bloomberg

We still expect central banks to gradually and slowly normalize interest rates as global economic growth remains robust and inflationary pressures pick up. In his first remarks to Congress, new Fed Chair Jerome Powell said that the Fed won't allow the economy to overheat and cause inflation to soar. Markets will focus on the March 21st statement and new economic projections, as Powell may follow a more rapid pace of tightening than is predecessor in the face of accelerating inflation. A significant rise in interest rates that does not coincide with an improving economic backdrop could negatively impact the credit space. The good news so far is that the rate selloff largely reflects expectations of robust economic growth with market-based inflation expectations hovering around their highs since September 2014, although there is still a chance that this might partly reflects increasing fears of trade war. We will closely track break-even inflation rates over the next few weeks to see how our investment recommendations need to be adjusted as losing momentum in market-based inflation expectations could well lead credit to underperform.

Model Portfolio as of March 2018				
Asset Classes & Regions	Recommended Weightings (%)	Benchmark Allocation (%)	Over/Underweights (%)	Recommendation
Bonds	50.0	50.0	0.0	=
Government	34.4	34.4	0.0	=
Corporate	15.6	15.6	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	+

Eric Corbeil, M.Sc., CFA, FRM | Senior Economist
Tel: 514 350-2925 | CorbeilE@vmbl.ca

Hugo Lacasse | Analyst
Tel: 514 350-3006 | LacasseH@vmbl.ca

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