Asset Allocation Model – December Update

Global equities made yet another high this month as global economic data remained robust and economic growth prospects kept being upgraded. On the other hand, the straight-line nature of the current equity rally has now pushed investor sentiment to historically high levels. For example, according to the most recent University of Michigan's Survey of Consumers, the mean respondent estimates that there is a 64.5% probability of an increase in the stock market in the next year, which ranks as the highest such reading in the survey's history. This should be a source of concern to investors as such market bullishness ultimately increases the risk of an imminent position squaring correction. We still remain positive on financial market prospects for now and still recommend clients to play the growth trade. However, rather than overweighting equities as our favored instrument to do so, we continue to prefer playing this trade through our regional and sector allocation. Hence, we remain comfortable with our neutral stance on equities against bonds 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 central bank monetary policies. With the output gap in the U.S. closing this year for the first time since the Great Recession and expectations that the output gap in Europe will close during 2018, this should exert upward pressure on inflation data. Rising inflationary pressures should lead to a growing shift in central bank monetary policy globally, which could ultimately weigh on stocks' price-to-earnings multiples. Another red flag for stocks is the remarkably long winning streak with the S&P 500 failing to post a more than 5% pullback since mid-2016, which represents the longest such streak since the mid-90s. However, any market pullback should prove temporary as the global economy is still expected to expand at a healthy rate in 2018 thanks to our expectations for robust business investment and consumer spending. Risk of a near-term recession also remains historically low at this time. Market valuations also remain reasonable when compared to government and corporate bond yields.

Regional & Sector 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 in 2018. Macroeconomic conditions also remain ideal for emerging markets, with low real rates, soft inflation measures, easy financial conditions and improving global trade. EM central banks 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. Forward earnings for emerging markets are also on the rise relative to developed markets, which represents another tailwind for EM equities. Emerging economies should fare well, benefiting from strengthening commodity prices.

There is no change to our sector allocation in both Canada and the U.S. this month. In Canada, we still advise clients to overweight the Industrials, Financials, Information Technology and Energy sectors. In the U.S., we recommend clients to overweight the Information Technology, Financials, Industrials, Materials and Energy sectors. We attribute most of the sharp rise in crude oil prices over the past few weeks to the fast normalization in excess inventories, which we had correctly anticipated. However, we remain worried about a coming pullback in crude oil prices as investor positioning is historically very long but a ``buying the dip`` strategy could be profitable as we remain comfortable with our call for crude oil prices to close above $60/bbl in 2018.

Canadian Bond Allocation

We maintain our neutral stance to corporate bonds this month as valuations is extremely rich and we are concerned that an increase in borrowing yields could hurt corporate fundamentals and the relative performance of credit. With the output gap in both the U.S. and Canada closing for the first time since the Great Recession, this should exert upward pressure on inflation data and negatively impact the profit margin outlook as margins historically tend to peak soon after output gaps close. Rising inflationary pressures should also lead to a growing shift in central bank monetary policy globally, which could lead to widening credit spreads. On the other hand, still easy financial conditions, rising earnings growth and low risk of a near-term recession should support the relative performance of credit by keeping defaults low in the near-term.

Model Portfolio as of December 2017				
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	22.4	20.0	2.4	+
United States	12.0	16.0	-4.0	-
Other Developed Markets	11.6	11.6	0.0	=
Emerging Markets	4.0	2.4	1.6	+

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