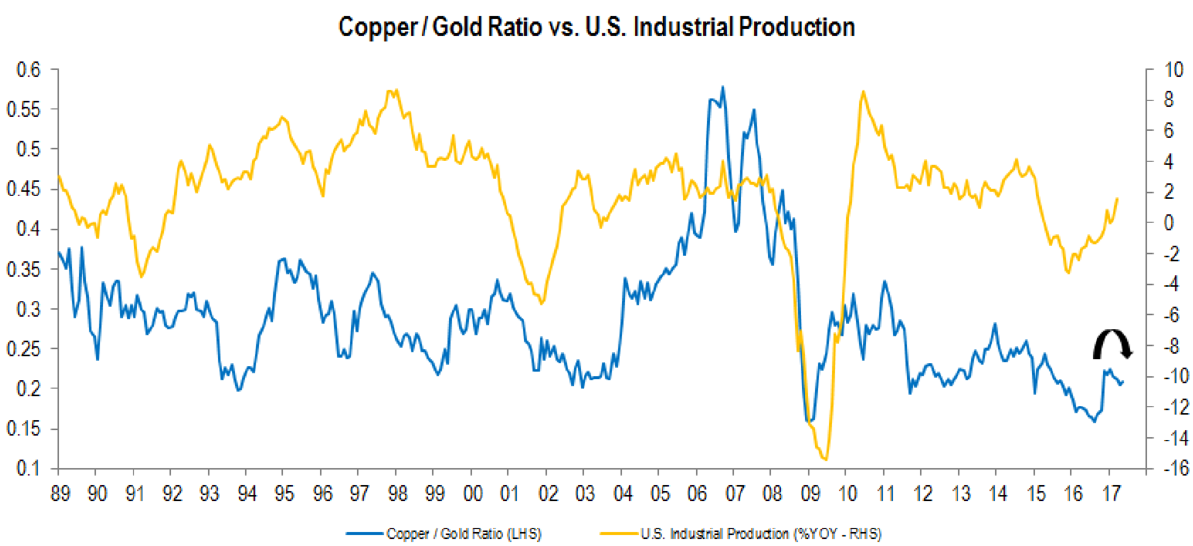
Laurentian Bank Securities
ECONOMIC RESEARCH AND STRATEGY

Asset Allocation Model – May Update

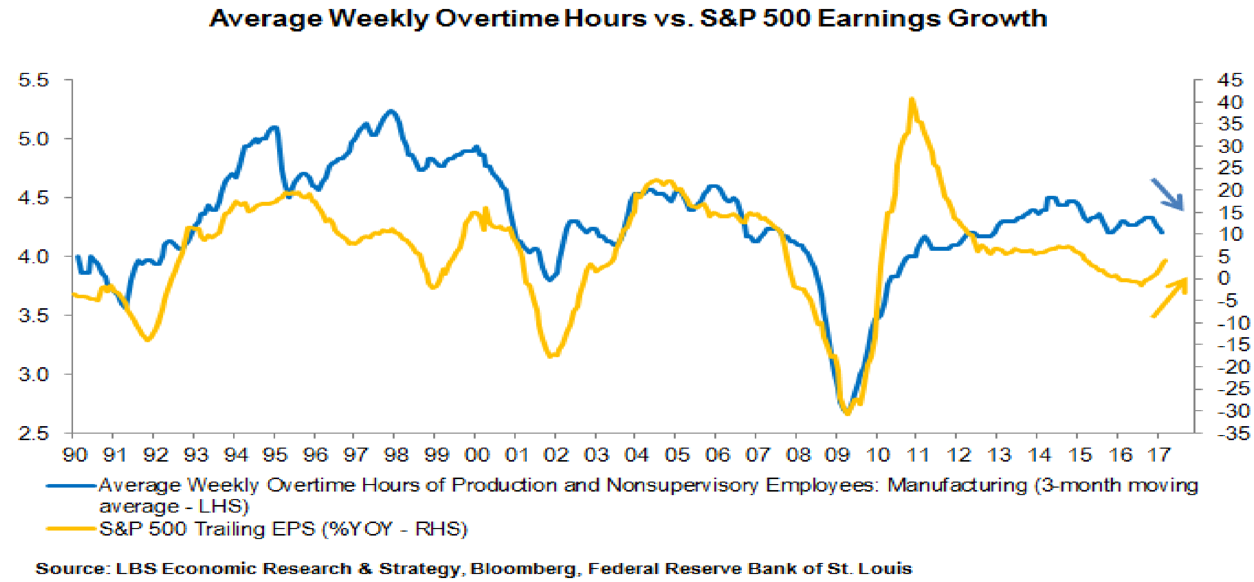
Global macroeconomic data in April generally continued to support the case for a continuation of the earnings acceleration phase that started in mid-2016, which is still proving supportive for risk assets. For instance, the ISM's Supplier Deliveries sub-index remained above the key 50 threshold for the twelve consecutive month in April with a reading greater than 50 indicating slower deliveries, which is a positive indication as it may reflect stronger demand. Turning points in the ISM Supplier Deliveries component historically tended to lead or coincide with turning points in the earnings cycle, which makes this indicator especially important to monitor. Moreover, global industrial production growth remains on the rebound, which also bodes well for corporate profits considering the strong historical correlation that exists between industrial production growth and earnings growth.

However, other leading indicators are also raising the probability of a coming moderation in economic momentum in the weeks ahead, which could lead to a coming tipping point in the earnings cycle and make equities highly vulnerable to disappointment. First, the recent underperformance of base against precious metals is pointing to a coming turnover in U.S. industrial production growth as the relative performance of base metals represents a good proxy for economic activity (see the chart below).



Source: LBS Economic Research & Strategy, Bloomberg

Second, March employment data in the U.S. also provided another source of concern with employment rising at its slowest pace since May 2016 and aggregate hours worked down from a year ago. As a result, inflation-adjusted growth in U.S. total labor income continued to decelerate during the month, which is not pointing to a coming acceleration in discretionary spending growth. In addition, overtime hours fell in March, which is reinforcing the case for a coming tipping point in the earnings cycle; a scenario we still expect to occur within the next three to six months (see the chart below).



Finally, the current weakening in real money supply growth, underperformance of small-cap stocks and flattening yield curve also point to a coming moderation in economic momentum. Moreover, many sentiment indicators and investor surveys continue to show historically high complacency and extreme optimism in the economic outlook, despite the elevated level of political uncertainties. Signs of extreme optimism include the recent increase in NYSE margin debt to a record high in March and the S&P 500 12-month forward PE-to-CBOE VIX ratio still standing at a new high since at least 1990. In addition to that, Citigroup's latest poll of pension, mutual and hedge fund investors showed that the median cash figure as a percent of assets under management remained at 3.5% in March, close to the lowest level seen over the past seven years. As a result, we remain comfortable with our decision to adopt a neutral stance on equity vs. fixed income at the end of January.

Regional Allocation and Sector Rotation

There is no change to our regional allocation this month with our largest overweight remaining Canadian equities as we expect the global oil market to tighten in the coming quarters due to the combination of supply cuts by OPEC and non-OPEC producers and rising global demand, which should exert a positive influence on oil prices. As for our sector allocation in Canada, we still recommend to overweight the Energy, Materials, Telecommunication Services, Industrials and Information Technology sectors. In the U.S., we still advise clients to overweight the Energy, Materials, Information Technology, Telecommunication Services, Real Estate and Consumer Staples sectors.

Canadian Bond Allocation

The ongoing earnings acceleration and strong economic backdrop should continue to be supportive of credit, in our view. However, we remain concerned that a tipping point in earnings momentum could be reached within the next three to six months, which could then lead the current rally in credit to take a pause. The recent decline in market-based inflation expectations and underperformance of transportation stocks represent another source of concern as it may point to a coming moderation in economic momentum, which could lead to a widening in credit spreads. We remain overweight credit for now as the macroeconomic backdrop remains strong with consumer confidence, forward profit margins and global earnings revision still improving. Under such conditions, we still see room for further spread compression although already tight spreads limit the room for a significant rally.

Model Portfolio as of May 2017				
Asset Classes & Regions	Recommended Weightings (%)	Benchmark Allocation (%)	Over/Underweights (%)	Recommendation
Bonds	50.0	50.0	0.0	=
Government	30.0	34.2	-4.2	-
Corporate	20.0	15.8	4.2	+
Equities	50.0	50.0	0.0	=
Canada	22.5	20.0	2.5	+
United States	15.0	16.0	-1.0	-
Other Developed Markets	9.6	11.6	-2.0	-
Emerging Markets	2.9	2.4	0.5	= / +

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