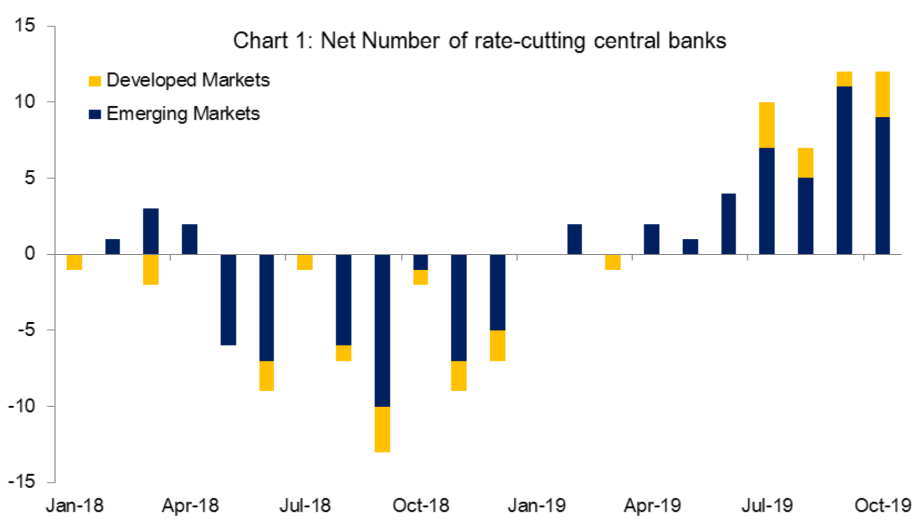
Tactical Asset Allocation (Nov. Update): Time to Benefit from a Possible Less Cloudy Outlook

In early October, our decision to raise our equity allocation from a moderate underweight position to neutral and to overweight U.S. vs Canadian equities proved insightful and generated a slightly higher return versus the benchmark. The United States and China made progress towards an agreement of a partial trade deal. A "Phase 1" deal, which remains to be signed, involves China buying more U.S. agricultural products, improving intellectual property protection and providing greater access to foreign financial companies. Although being short of a comprehensive deal, the markets welcomed the news. The S&P 500 and the MSCI World were both up by 2.2% and 3.2% respectively for the month of October. On the other hand, the S&P TSX witnessed a decline of 0.9% and fixed income indices displayed a small loss. Although President Trump said in early November that he has not agreed to roll back tariffs as media reported, renewed trade optimism could bring more than a glimmer of hope in respect to the 2020 economic and earnings outlook.

The outlook appears less gloomy

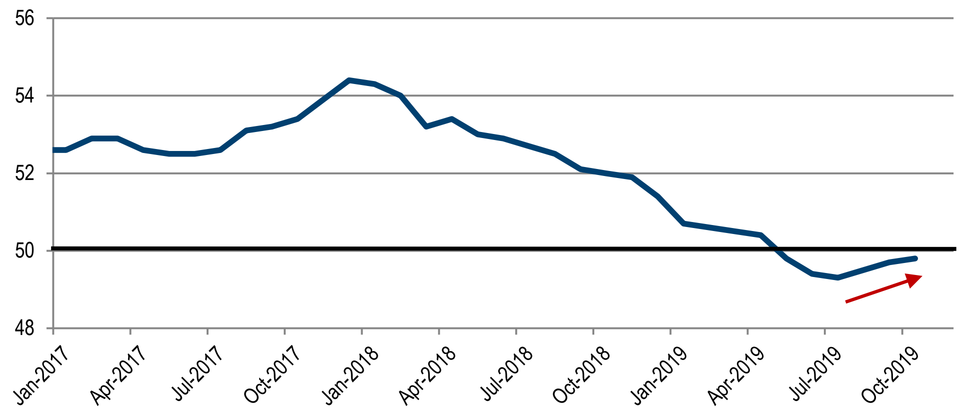
Tactically, trade optimism is likely to keep the "R" word at bay for some time. The growing odds of an imminent interim trade deal would dissipate some of the business and market uncertainty associated to economic policies, therefore providing eventually a modest boost to both U.S. and Chinese economies.

Furthermore, the IMF recently downgraded its global real GDP forecasts to its lowest since 2008-09 (by 0.3ppt, to 3.0% in 2019 and by 0.2ppt, to 3.4% in 2020). Thus, the bar is generally set low in our view to beat expectations. Also, as per the IMF calculations, about 70% of the world's central banks, weighted by GDP, have shifted to an easier stance on monetary policy. Even if the Federal Reserve signaled a pause in late October, the global easing trend is still continuing, led by emerging markets (Chart 1). The greater efficiency of the on-going monetary tailwind in emerging markets, less constrained by the zero bound than in industrialized countries, usually supports corporate earnings growth and will help to contain possible downside risks by the time it filters through the real economy.



Moreover, there are signs that the weakness in the global manufacturing sector caused by the trade war may be ebbing. The J.P. Morgan Global Manufacturing PMI stood at 49.8 in October, very close to the neutral mark of 50. October's figure marks a third successive improvement (Chart 2). The new orders component of the PMI, a gauge of future production of manufactured goods, displayed a relatively encouraging reading of 50. If the 49.3 Global Manufacturing PMI reading of last July turns out to be the trough, the contraction of manufacturing activity would have been short-lived and very modest. During the 2008-09 recession, this PMI figure stood between 35 and 45 for several months. Altogether, we believe that the risk of negative spillover effects from the manufacturing sector to the service sectors has marginally subsided. As such, markets' trade fears are abating. Our view is reinforced by the acceleration in activity for U.S. services companies during the month of October, as indicated by the 54.7% ISM non-manufacturing index.

Chart 2: Global Purchasing Managers' Index (PMIs)

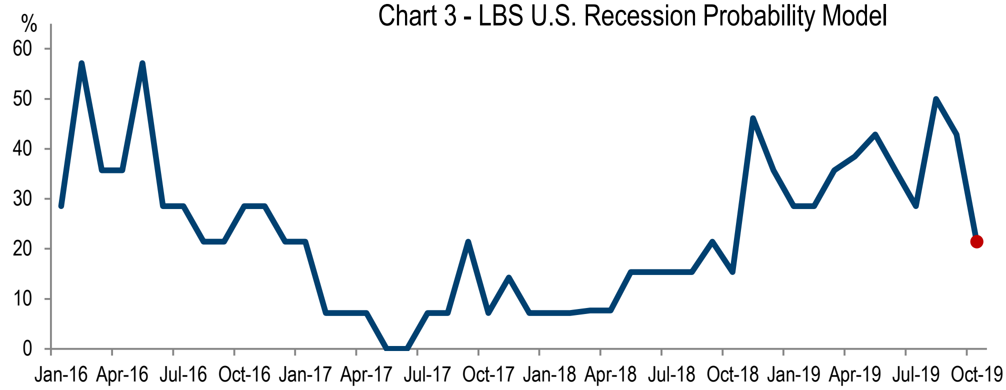


*50 = no change. Source: Thomson Refinitiv/J.P. Morgan/Markit.

Those early signs of stabilization in global manufacturing and merchandise trade activities have already been captured by our U.S. recession model. The risk of a downturn in the next 6-to-12 months has decreased to 21%, down from the 40%-50% range observed in August and September (Chart 3). Indeed, several leading indicators of the cycle included in our U.S. recession model have turned positive recently:

- We notice a positive m/m change in the 6-month moving average of the Cass Freight Index Shipments, a monthly indicator of shipping volumes in North America.
- For the first time since October 2018, the m/m change in the 3-month moving average change in the Conference Board U.S. coincident-to-lagging ratio turned positive.
- For the first time since last March, the monthly change of the 3-month moving average y/y U.S. wage bill growth rate has increased.
- The steepening of the yield curve reflects the market's view that the Fed's policy rate is now at the right place rather than being too high relative to the outlook and relative to the record-high private and public debt burden (as a % share of GDP). As of mid-November, we have witnessed the biggest 5-week widening in the US 3M-10Y spread since the post-market reaction to Trump's win at the 2016 Presidential election.

Chart 3 - LBS U.S. Recession Probability Model



Note: The probability of a recession is over the next 6-12 months.
Sources: Bloomberg Finance L.P., Thomson Reuters and LBS Economic Research and Strategy.

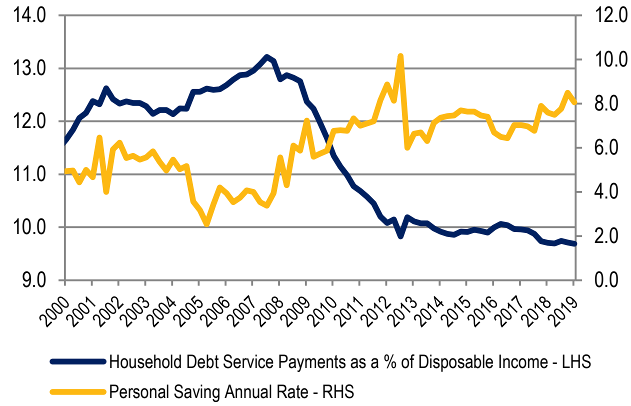
Granted, we strategically continue to remain prudent given the widening in U.S. high yield spreads and the deceleration of the global ZEW financial market sentiment. However, taking into considerations all the above-mentioned factors reducing the tail risk of a severe deterioration in economic conditions, from a tactical perspective, we have decided to slightly overweight equities.

Overweight U.S. equities on the back of the resilient U.S. consumer

From a geographical perspective, we maintain our overweight recommendation towards U.S. equities on the back of a resilient U.S. consumer. We expect the U.S. consumer to spend at a healthy pace. It supports the continuous economic outperformance of the U.S. relative to other countries and is likely to offset the fact that the S&P 500 remains above our fair value estimate. First, our view is supported by strong households' balance sheets: the household debt service ratio stands at historical lows, the saving rate is well above its long-run average and the 3% y/y appreciation in housing prices translates into a modest positive wealth effect (Chart 4). Second, growth in the wage bill after core PCE inflation has bottomed out to a still strong 2% y/y rate and the persistently low inflation expectations are unlikely to erode the purchasing power of Americans (Chart 5).

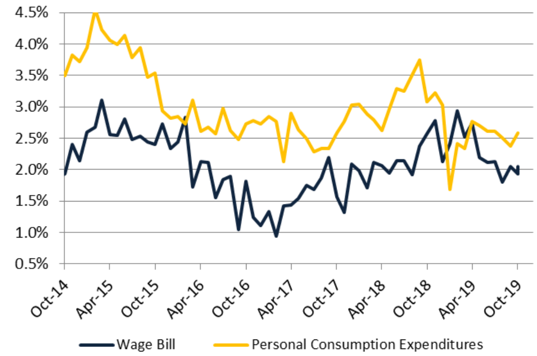
Thus, from a sectoral perspective, we recommend to overweight both **consumer discretionary** and **consumer staples** in the U.S. Also, we suggest to overweight U.S. cyclical industries like **financials** and **info tech** which tend to outperform when the probability of a recession decreases. Furthermore, a strong earnings momentum still supports adding **healthcare** and **telecom** in the U.S.

Chart 4: American Household Balance Sheet (in %)



Source: FRED, LBS Economic Research and Strategy.

Chart 5: The U.S. Wage Bill and Consumer Spending in Real Terms (y/y % change)



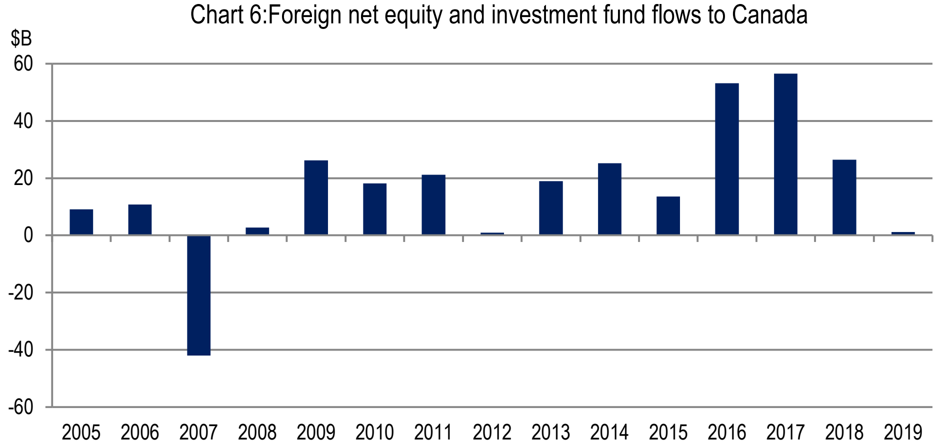
Source: Bloomberg, LBS Economic Research and Strategy
The wage bill is the total amount of wages paid in the U.S. deflated by PCE

Increasing allocation to Canadian and EM equities

Compared to last month, we have increased our equity allocation to Canada from underweight to neutral, as supported by the improving dynamic of some short-term economic indicators: the Canada-U.S. unemployment rate gap has tightened and the U.S. dollar has slightly weakened against a basket of major currencies. However, we prefer to keep a neutral stance for now, unless we see, among other things, signs of a positive turnaround in equity foreign flows. So far this year, Canadian stocks have witnessed the smallest gain in net foreign flows since 2012 (Chart 6).This is mainly due to the energy sector, which makes about 16% of the S&P TSX index. Similar to the U.S., we favor the **financials**, **telecom**, **consumer discretionary**, **consumer staples** and **info tech sectors** in Canada. The less gloomy outlook also leans in favor of materials excluding the TSX gold index.

Finally, we have increased our allocation to overweight in emerging markets favoured by an increase in money supply in China and a weaker short-term momentum in the DXY, two signs of a risk-on behavior. Also, macroeconomic conditions are likely to remain favorable in light of soft inflation measures and easing financial conditions.

Chart 6:Foreign net equity and investment fund flows to Canada

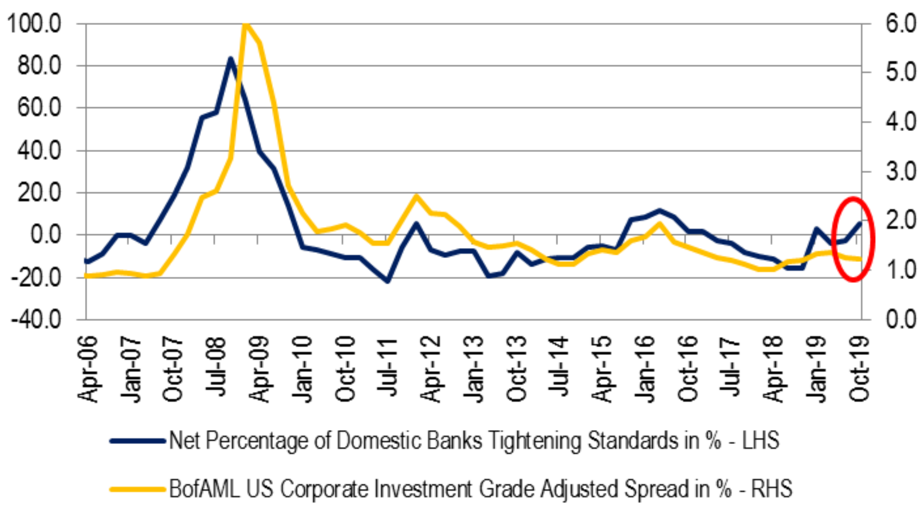


Source: Statistics Canada, LBS Economic Research and Strategy.

Keeping a neutral stance within the underweight bond allocation

Although we assume some risk on the equities side, we prefer to stay neutral on the credit side with a 70/30 allocation to government and corporate bonds respectively, which is in line with our benchmark. On one hand, an accommodative stance from central banks and a continued search for yield among institutional investors still favor Canadian corporate bonds versus government bonds. On the other hand, slightly lower expectations for S&P 500 profit margins and tighter lending standards as displayed by the October Federal Reserve Senior Loan Officer Opinion Survey (SLOOS) are less favorable for credit. One reliable SLOOS figure shows that the net percentage of domestic banks tightening standards for commercial and industrial loans to large and middle-market firms is the highest since mid-2016. Credit spreads closely track the SLOOS (Chart 7); therefore we will closely monitor those credit metrics, as a further widening of credit spreads following a tightening in credit conditions could further deteriorate the profit margins of U.S. companies.

Chart 7: U.S. Corporate Financing Conditions



Source: FRED, LBS Economic Research and Strategy

Recommended Portfolio as of November 2019				
Asset Classes & Regions	Recommended Weightings (%)	Benchmark Allocation (%)	Over/Underweights (%)	Recommendation
Bonds	45 (50)	50.0	-5.0	-
Government	31 (34.4)	34.4	-3.4	-
Corporate	14 (15.6)	15.6	-1.6	-
Equities	55 (50)	50.0	5.0	+
Canada	20 (18)	20.0	0.0	=
United States	20 (20)	16.0	4.0	+
Other Developed Markets	11.6 (9.6)	11.6	0.0	=
Emerging Markets	3.4 (2.4)	2.4	1.0	+

Note: Numbers in bracket represent previous month allocation.

Source: LBS Economic Research and Strategy.

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