Asset Allocation Model – May Update

For the month of May we still remain neutral on equities against bonds, waiting for some of the fog related to global trade negotiations to clear up before committing to a riskier position in equity. A premature slowdown of the global economic momentum caused by lingering international trade's disputes would negatively affect equity markets, even if bond yields would probably fall in such a scenario. Beyond trade concerns, there are also other reasons to worry about the rosy economic outlook for 2018 and beyond. A tight labor market in the U.S., aggressive tax cuts and increased government spending could force the Fed to react quickly to prevent inflation from running too high, leading to higher interest rates and lower equity market multiples.

The good news is that, in our view, the macroeconomic backdrop remains solid despite the recent increase in borrowing rates, market jitters about globalization and geopolitical tensions. U.S. Business indicators in particular, such as the earnings per share, are still on the rise. Initial jobless claims also fell to the lowest level since 1969 and the Conference Board index of consumer confidence is still rising. All support the case for an economy that is able to digest higher rates if monetary tightening is gradual as we think it will be. Emerging market equity also fared well against developed market equity during the recent 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 is also consistent with robust economic growth. However, we remain concerned that growing headwinds for equities over the coming months could be coming from trade tariffs between the U.S. and China, the derailing of NAFTA talks, unforeseen accelerating inflation, a Fed reserve that would tighten monetary policies too aggressively as well as a deteriorating geopolitical environment with live crises in Iran, Syria, Venezuela, Libya and North Korea among other places. As a result, we maintain our neutral stance on equities for the month of May.

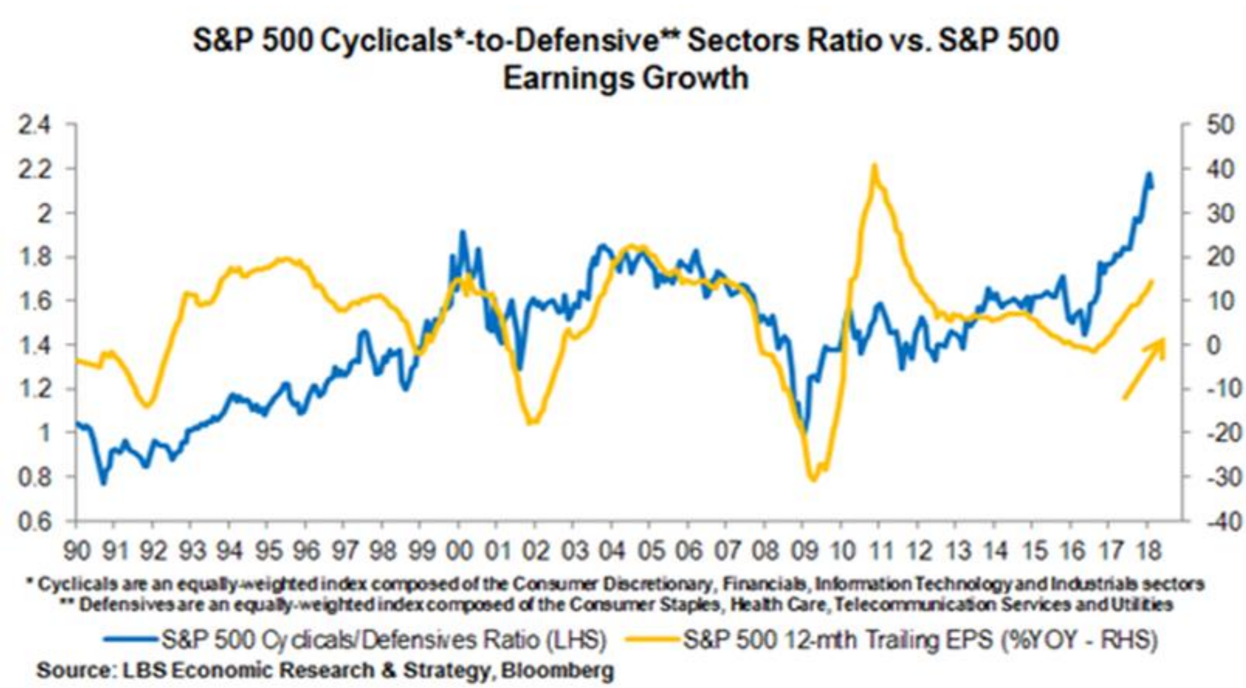
Regional Allocation

There is no major 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 Canadian crude oil prices to rise further in 2018 on the back of a tightening global oil market and as constraints on market access in Canada get resolved. The combination of robust global economic growth, accelerating emerging market growth and high OPEC compliance with their agreed production cuts should help to keep the oil market relatively tight this year. The increased likelihood that President Trump cancels the Iran nuclear agreement and imposes new sanctions on Iran in mid-May could also help to push up oil prices further.

We also maintain our overweight in emerging market equities as they remain cheap relative to developed market equities. Macroeconomic conditions remain ideal for emerging markets, with low real interest 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.

Sector Allocation

Our sector allocation is mostly the same for the month of May relative to April. We are recommending that clients overweight positions in the **Industrials**, **Financials**, **Energy** and **Consumer discretionary** sectors in the U.S. and Canada. For Canada, we also recommend to keep an overweight in the **Materials** sector. Moreover, we opted to include the **Information Technology** sector among the sectors to overweight in the U.S. as the recent market correction has lowered market valuation.



Our expectations for earnings growth to continue accelerating and economic growth to remain robust in the near term, combined with still easy financial conditions, largely support our call to still favor a majority of cyclical assets over defensive sectors; this in spite of their relative elevated valuations. Moreover, earnings growth in cyclical sectors relative to that of defensive sectors continues to accelerate, supporting the outperformance of cyclicals. Our expectations for mildly accelerating inflation data should also contribute positively to the relative performance of the Energy sector which historically tends to outperform the broader market during episodes of higher inflation.

Canadian Bond Allocation

We maintain our neutral stance on corporate bonds this month as valuation remains historically rich, especially when adjusted for elevated corporate leverage. We remain concerned by the unavoidable decelerating global economic momentum, the eventual slowdown in earnings growth and central banks withdrawing stimulus. All of these factors will ultimately hurt the relative performance of credit in the second half of the year. Moreover, with the output gap in both the U.S. and Canada closing for the first time since the Great Recession, we should expect further upward pressure on inflation data which would negatively impact the profit margin outlook of corporations as margins historically tend to peak soon after the output gap closes. We are not calling for corporate spread to get wider in May. However, as they are historically tight with little to be gained in terms of further compression and as the timing of a credit spread reversal is notoriously difficult to forecast, we prefer remaining neutral for now.

Model Portfolio as of May 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	11.6	11.6	0.0	=
Emerging Markets	4.4	2.4	2.0	+

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