Laurentian Bank Securities

ECONOMIC RESEARCH AND STRATEGY

Asset Allocation Model Update: Cautiously Staying In

The decision in early October to remain neutral on equities despite the bullish signals proved insightful. Starting October 4th, global equities fell drastically. Notably, the S&P 500 index bottomed at 2641 on October 29, almost 10% lower than its near-record high levels reached in early October. In fact, last month's rout (-6.9% between the end of September and October 31st) was the steepest decline in the U.S. benchmark index since September 2011, more than seven years ago. Other major equity indexes did not fare better (see Table 1). North American bond markets were also affected with long-term yields rising slightly and credit spreads widening. Exact causes of the selloff are multiples and not clear-cut. For instance, Federal Reserve Chairman Jerome Powell's comments about the economy no longer needing accommodative interest rates on October 3rd might have been a catalyst. However, the general selloff came against a generally good Q3 earnings season with 74% of S&P companies reporting positive EPS surprise and 61% reporting positive sales surprise as of November 2 according to Factset. In reality, comments made about global risks and geopolitical tensions by senior executives at large industrials and materials companies such DowDuPont, 3M and Caterpillar might have send conflicting signals despite positive financial results.

Table 1: Widespread Declines in Equity Markets

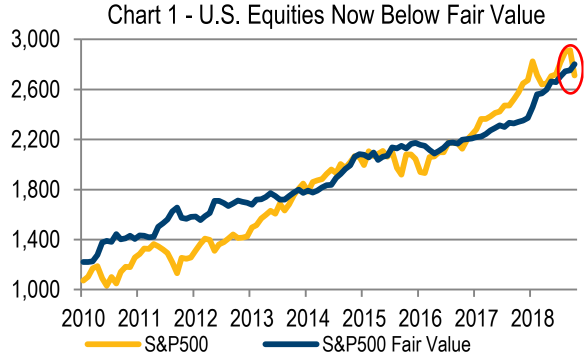
	% Return
Equities	**Oct-18**
MSCI All Country World Index	-7.6
MSCI Developed Markets	-7.4
MSCI Emerging Markets	-8.8
S&P 500	-6.9
S&P TSX	-6.5
Bonds	
BofAML Global Fixed Income Market Index	-0.4
Ishare Canadian Core Universe Bond Index ETF	-0.7

Sources: Bloomberg Finance L.P., LBS Econ. Res. And Strategy.

Attractive Valuations, But Staying Neutral

The October selloff has made equities more attractive on a valuation basis. For instance, the S&P 500 is now 3.3% below our fair value estimates, a first since February 2016 (see Chart 1). However, other indicators in our asset allocation model now recommend staying neutral on equities versus bonds. The large increase in volatility experienced in November has led one of our preferred measures of investor's sentiment, the S&P 500 forward 12-mth P/E ratio divided by the CBOE VIX Index, to render a negative signal. Moreover, the increase in high yield credit spreads, small in basis points, but large in relative percentage terms as well as the negative performance of global equities relative to bonds favor a 50/50 allocation of bonds versus equities (see Table 2 below).

Chart 1 - U.S. Equities Now Below Fair Value



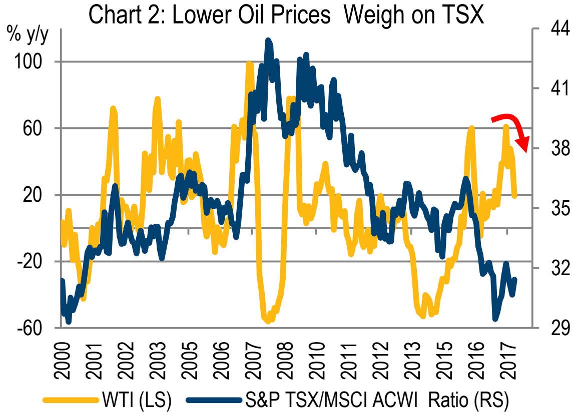
Note: Fair value based on Treasury yields, crude oil prices and the trade-weighted U.S. dollar.
Source: Thomson Reuters and LBS Econ. Res. and Strategy.

Looking to the month ahead, several important economic events may very well prevent a quick recovery in stocks. The U.S. mid-term election, on November 6th, could see Democrats take control of the House of Representatives. Would that be the case, while the Republican Party keeps control of the Senate, the United States could end up in a political gridlock where anything from budget plans, debt ceiling and appropriations to keep the Government in operation would be hard to pass. Moreover, the United States-Mexico-Canada-Agreement (USMCA) has not been ratified yet by Congress and there is a possibility that a Democratically-controlled House could demand modifications to the agreement. This would add uncertainty to the North American Outlook. Finally, the upcoming G-20 meeting, to be held in Argentina at the end of the month, might be decisive for the U.S.-China trade spat. The U.S. President has already announced his intention to impose a 25% tariff on all remaining 257 $US Chinese imports if no deal is reached on trade with the Chinese Government.

Some Geographical Reallocation

We also recommend rebalancing the portfolio towards a neutral geographical allocation, versus our October overweight position in Canada and underweight position in the United States. For one, crude oil prices are low and will continue to weigh in the short-run on the important energy sector in Canada (19% of the S&P TSX Index; see Chart 2). Moreover, the record-high discounts on the Western Canadian Select (WCS) relative to the WTI, while expected to recede somewhat during the month, is still expected to weigh on the earnings outlook of Canadian oil companies.

Chart 2: Lower Oil Prices Weigh on TSX



Sources: Bloomberg Finance L.P. and LBS Econ. Res. and Strategy.

While we will be keeping an eye on some short-term leading indicators, such as a slight upward momentum in U.S. initial jobless claims, the foundations of the U.S. economy still look solid and justify our decision to eliminate our underweight position in US equity. On the other hand, the very weak performance of emerging markets equities in recent months leads us to cut our overweight exposure to this segment. We will monitor developments in China such as new simulative policies from President Xi and the performance of leading economic indicators in that region relative to developed markets to assess if an overweight position can be taken again later.

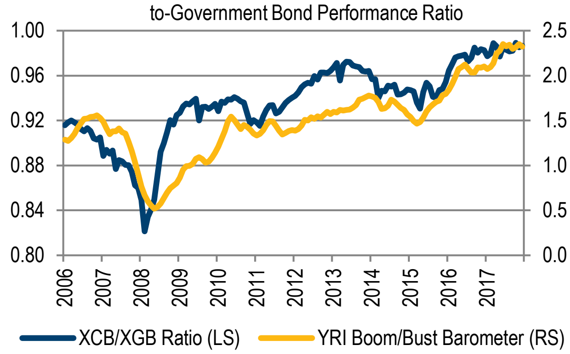
Cyclicals: The Hardest Hit

While our decision to remain neutral on equities in October was prudent, we assumed some bullishness through overweight positions in cyclical industries, both in the United States and in Canada; sectors that were hit the hardest in October. For example, the **information technology**, **financials**, **consumer discretionary**, **industrials** and **energy** sectors declined by 8.2%, 5.1%, 11.1%, 11.2% and 11.8% in the U.S., respectively. Lesser declines were experienced in Canada. However, earnings momentum continues to favour those sectors. They are also poised to benefit more from an equity recovery if this scenario materialises. Hence, we continue to recommend overweighting these cyclical sectors rather than overhaul the entire portfolio based on a single month's returns.

Time To Reduce Credit Risk

Finally, after keeping a neutral position on our credit versus governmental bond allocation for more than a year, several indicators, such as a negative momentum in the Yardeni Boom/Bust Barometer - which usually correlates well with the relative performance of Canadian corporate versus government bond - suggest reducing exposure to corporate debt (see Chart 3). It is true that high yield spreads widened slightly in October, but those instruments continue to remain very expensive historically. Further widening, caused by a spike in volatility or a crisis of confidence towards corporate debt, could lead to major losses in that sector. Therefore, for November, we recommend to slightly underweight corporate bonds into the Canadian asset mix.

Chart 3: Yardeni Boom/Bust Barometer and Corporate-to-Government Bond Performance Ratio



Source: Yardeni Research Inc., Bloomberg Finance L.P. and LBS Econ. Res. and Strategy.

Table 2: Model Portfolio as of November 2018				
Asset Classes & Regions	Recommended Weightings (%)	Benchmark Allocation (%)	Over/Underweights (%)	Recommendation
Bonds	50.0	50.0	0.0	=
Government	38.0	34.4	3.6	+
Corporate	12.0	15.6	-3.6	-
Equities	50.0	50.0	0.0	=
Canada	20.0	20.0	0.0	=
United States	16.0	16.0	0.0	=
Other Developed Markets	11.6	11.6	0.0	=
Emerging Markets	2.4	2.4	0.0	=

Luc Vallée | Chief Strategist
514 350-3000 | valleel@vmbl.ca

Dominique Lapointe | Economist
514 350-2924 | lapointed@vmbl.ca