Asset Allocation Strategy

CIO Office | May 2024

2024 ≠ 2022

Highlights

- U.S. inflation drove markets nervousness up a notch in April, with the S&P 500 ending five months of virtually uninterrupted ascent, while bonds continued to retreat. Is a new edition of 2022 in the offing?
- The persistence of inflation – which is largely explained by services – would be far more worrying if an overheated job market was still in evidence. However, it appears to be the opposite, with hiring intentions at their lowest since 2016 and workers increasingly worried about losing their jobs. What's more, with excess savings "officially" exhausted, we can assume that consumer demand is likely to become more sensitive to price rises.
- Besides, despite a significant rise in tensions in the Middle East, a shock to oil prices similar to that which occurred during the Russian invasion in 2022 seems relatively limited.
- As in a marathon, crossing the last mile separating inflation from its target is the most arduous stage, as the Fed seeks to ensure the perfect level of economic activity to reach its destination... without slipping into recession.
- In the short term, this environment is likely to result in volatile but trendless bond and equity markets. As a result, we are maintaining our balanced allocation between equities and bonds.
- Within equities, after an historic outperformance of the quality factor in the U.S., profit-taking was called for. In return, a value bias via the equally-weighted S&P 500 Index could benefit from a leadership reversal and a recovery in the manufacturing sector.

Table 1 Global Asset Allocation Views

	− ⟵ = ⟶ +	Δ
Asset Classes		
Cash		
Fixed Income		
Equities		
*Alternatives**	+	
Fixed Income		
Government		
Investment Grade		
High Yield		
Duration	+	
Equities		
Canada	−	
United States	++	
EAFE	+	
Emerging Markets	−−	
Value (vs. Growth)	+	↑
Small (vs. Large)	−	
Cyclicals (vs. Defensives)		↑
Alternatives & FX		
Inflation Protection		
Gold		
Non-Traditional FI		
Uncorrelated Strategies	++	
Canadian Dollar	−	

This table is for illustration purposes only. Bars represent the degree of preference of an asset relative to the maximum deviation allowed from a reference index. The further to the right (left) they are, the more bullish (bearish) our outlook for the asset is. No bars indicate a neutral view. The column under the delta sign (**Δ**) displays when our outlook has improved (↑) or worsened (↓) from the previous month. Consult **Table 3** to see how they translate into a model balanced portfolio. *For tactical portfolios featuring alternative assets, the position is financed 1/3 by equities and 2/3 by bonds.

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Market Review

Fixed Income

- The resilience of the the U.S. economy and stronger-than-expected inflation have led markets to pare back their rate-cut expectations in 2024. As such, bonds continued to struggle and the Canadian fixed-income universe posted its worst month of the year with a decline of 1.9%.
- South of the border, the lower duration of High Yield bonds led them to outperform Investment Grade securities in an environment of rising interest rates.

Equities

- Global equities finished the month lower as market sentiment turned amidst escalating geopolitical tensions and the prospects of a more hawkish Fed. Emerging Markets fared slightly better than the rest of the world, buoyed by good performance in the Chinese stock market.
- In the U.S., Energy and Utilities outperformed, both benefitting from rising energy prices. On the other hand, higher bond yields weighed on Real Estate and the Small Caps of the Russell 2000.

FX & Commodities

- Gold prices reached new highs in April as momentum for the yellow metal remained strong. Meanwhile, copper prices increased significantly and ended the month just slightly below their all-time high of March 2022.
- The performance gap between the U.S. economy and the rest of the developed world continued to widen, leading to further appreciation of the USD, which is now up nearly 5 % since the start of the year.

Table 2 Market Total Returns

Asset Classes	April	YTD	12M
Cash (S&P Canada T-bill)	**0.4%**	**1.6%**	**4.9%**
Bonds (ICE BofA Canada Universe)	**-1.9%**	**-3.2%**	**-0.9%**
Short Term	-0.4%	0.1%	2.8%
Mid Term	-1.9%	-3.0%	-1.7%
Long Term	-4.2%	-7.9%	-5.8%
Federal Government	-1.6%	-2.8%	-1.3%
Corporate	-1.2%	-1.1%	3.0%
S&P/TSX Preferred Shares	1.2%	11.0%	14.6%
U.S. Corporate (ICE BofA US$)	-2.3%	-2.4%	1.4%
U.S. High Yield (ICE BofA US$)	-1.0%	0.5%	8.9%
Canadian Equities (S&P/TSX)	**-1.8%**	**4.7%**	**8.7%**
Communication Services	-1.8%	-10.2%	-21.5%
Consumer Discretionary	-0.9%	3.6%	8.4%
Consumer Staples	-0.8%	3.2%	5.9%
Energy	1.1%	14.3%	18.9%
Financials	-2.8%	2.6%	11.3%
Health Care	-5.3%	12.1%	24.5%
Industrials	-6.1%	4.3%	8.9%
Information Technology	-5.8%	-1.3%	30.1%
Materials	5.9%	12.1%	-0.9%
Real Estate	-6.8%	-5.3%	-5.4%
Utilities	-3.3%	-4.4%	-12.4%
S&P/TSX Small Caps	0.2%	8.1%	9.7%
U.S. Equities (S&P 500 US$)	**-4.1%**	**6.0%**	**22.7%**
Communication Services	-2.1%	13.4%	41.3%
Consumer Discretionary	-4.3%	0.4%	24.3%
Consumer Staples	-0.9%	6.6%	2.5%
Energy	-0.8%	12.8%	13.0%
Financials	-4.2%	7.8%	24.0%
Health Care	-5.1%	3.3%	6.9%
Industrials	-3.6%	7.0%	23.6%
Information Technology	-5.4%	6.6%	37.5%
Materials	-4.6%	3.9%	12.3%
Real Estate	-8.5%	-9.0%	-0.7%
Utilities	1.6%	6.3%	0.2%
Russell 2000 (US$)	-7.0%	-2.2%	13.3%
World Equities (MSCI ACWI US$)	**-3.3%**	**4.8%**	**18.0%**
MSCI EAFE (US$)	-2.5%	3.3%	9.8%
MSCI Emerging Markets (US$)	0.5%	2.9%	10.3%
Commodities (GSCI US$)	**1.2%**	**11.6%**	**13.3%**
WTI Oil (US$/barrel)	-0.6%	16.1%	8.8%
Gold (US$/oz)	3.7%	11.2%	15.4%
Copper (US$/tonne)	12.8%	16.9%	15.3%
Forex (US$ Index DXY)	**1.6%**	**4.8%**	**4.5%**
USD per EUR	-1.0%	-3.2%	-3.1%
CAD per USD	1.8%	4.0%	1.7%

CIO Office (data via Refinitiv, as of 2024-04-30)

Growing nervousness…

Market anxiety rose a notch in April, with the S&P 500 ending five months of virtually uninterrupted ascent as it tested its 100-day moving average near the 5,000 mark (**Chart 1**).

1 | The S&P 500 pulls back on its moving averages...

CIO Office (data via Refinitiv).

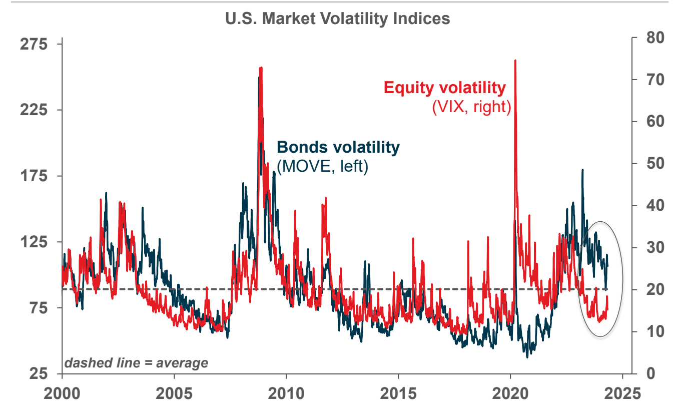
Meanwhile, the rise in benchmark 10-year yields observed since the start of the year gathered pace (**Chart 2**), resulting in declines for most bond indices.

2 | … while bond yields move away from them

CIO Office (data via Refinitiv).

All in all, we're seeing a certain increase in market volatility, although the situation is far from dramatic – the VIX Equity Volatility Index remains below its historical average, while its bond market counterpart is slightly above (**Chart 3**). Let's look at the source of these concerns.

3 | Modest rise in market volatility

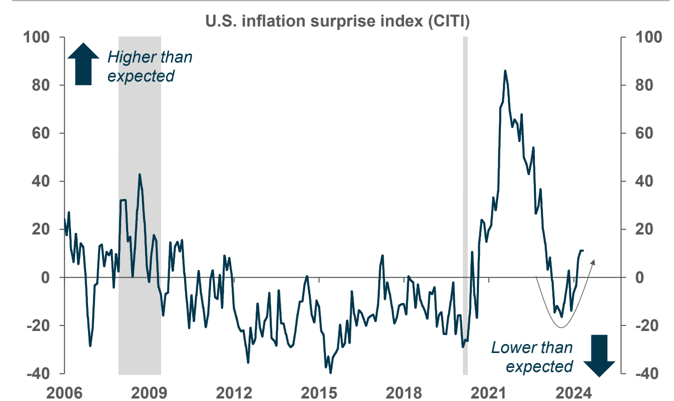


CIO Office (data via Refinitiv).

… sticky inflation

While the end of 2023 was characterized by a succession of lower-than-expected inflation figures, the exact opposite has occurred in the United States since the start of this year (**Chart 4**).

4 | Inflation surprises on the upside again...

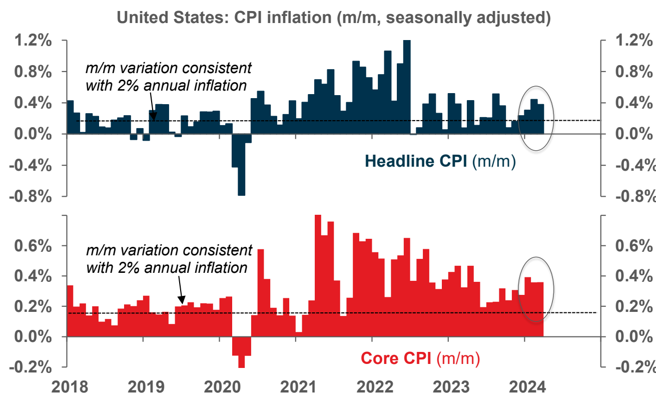


CIO Office (data via Refinitiv).

Indeed, not one, not two, but three consecutive inflation reports turned out to be stronger than expected and, above all, well above levels consistent with the 2% target south of the border (**Chart 5**, next page).

By way of illustration, if the pace observed since the start of the year were to be maintained over the next 12 months, annual inflation would gallop to levels almost as disturbing as in 2022. To be clear, this theoretical scenario is highly improbable. But, even a more conceivable hypothesis in which the trend of the past year persists shows that reaching

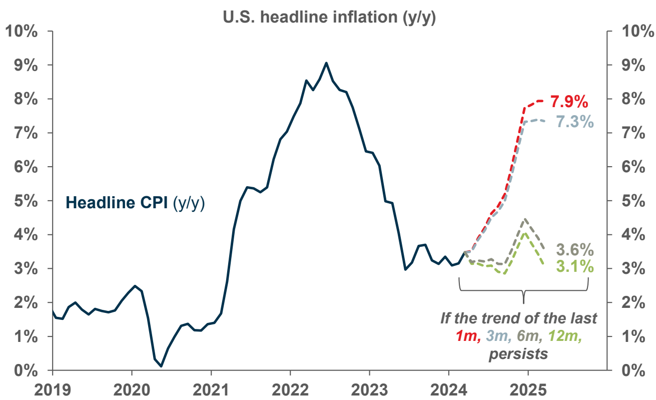
5 | ... for a third consecutive month in the U.S.



CIO Office (data via Refinitiv).

2% is looking difficult, while base effects are likely to push the annual inflation rate back up at the end of 2024 (**Chart 6**).

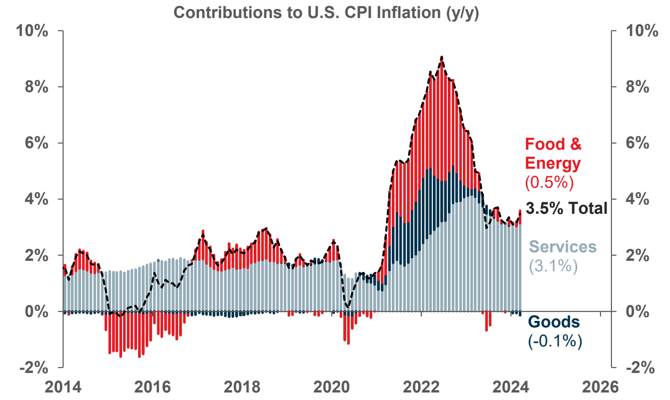
6 | Recent trends are problematic



CIO Office (data via Refinitiv).

That said, beyond simple arithmetic effects, the real challenge for inflation lies in services. Since last summer, this category has accounted for almost all of the annual rise in prices (**Chart 7**).

7 | The heart of the problem: services inflation



CIO Office (data via Refinitiv).

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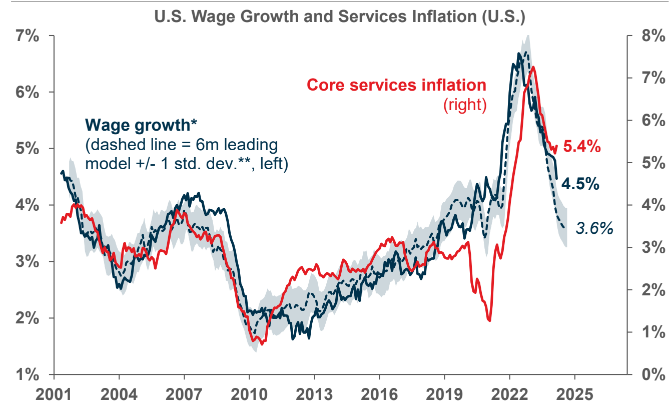
In principle, services inflation is two things: (1) driven by the price of labour, and (2) lagging. In 2022, wages were rising at breakneck speed, pointing to a sharp rise in the price of services... and that's exactly what happened. Today, after a period of stagnation, wage growth has begun to slow again, and all the signs are that this trend will continue, ultimately allowing service prices to slow in their turn (**Chart 8**).

8 | Wages are slowing...



CIO Office (data via Refinitiv). *Average between the Atlanta Fed measure and average hourly earnings (adjusted for extreme movements due to sector composition early in the pandemic). **Linear regression based on (1) job openings (indeed and JOLTS) vs unemployed, (2) NFIB "hard to fill jobs", (3) NFIB "plan to increase wages", (4) consumer sentiment "jobs plentiful", (5) JOTLS quits rate.

In other words, the persistence of services inflation would be far more worrying if the job market were still overheating. However, it looks like it's the other way around. For example, while the proportion of small businesses intending to hire was at an all-time high in 2022, it is now at its lowest level since 2016 (excluding March-April 2020, **Chart 9**, next page).

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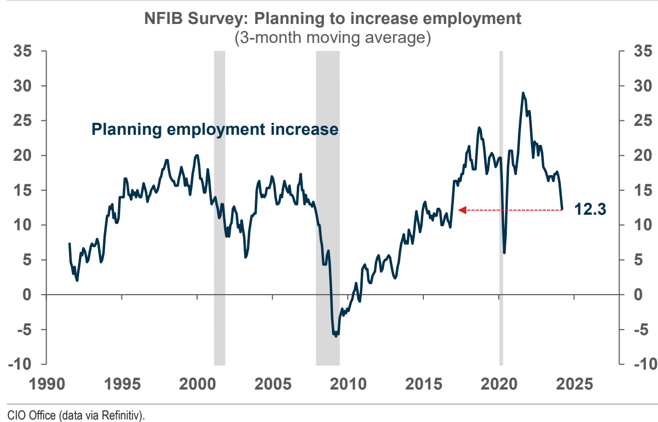
9 | ... as fewer companies plan to hire...



CIO Office (data via Refinitiv).

Similarly for workers, the latest New York Fed survey revealed a marked increase in the perception of the risk of losing one's job, coupled with a fall in the probability of finding a new job (**Chart 10**).

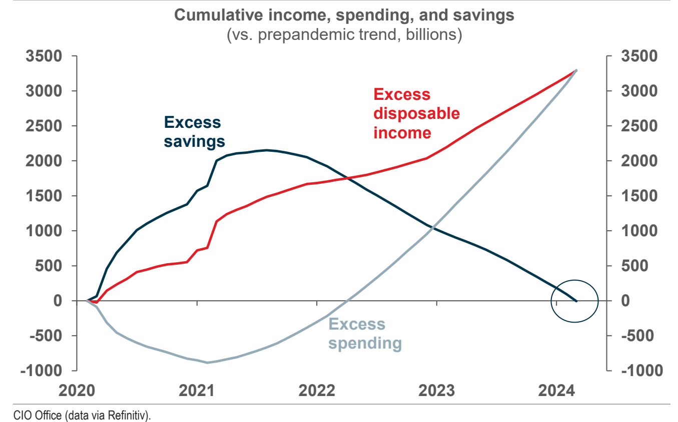
10 | ... and more consumers fear for their jobs…

CIO Office (data via Refinitiv).

Add to this the fact that excess savings of over US$2 trillion are "officially" exhausted according to the most recent data (**Chart 11**), and we can assume that consumer demand is likely to become increasingly sensitive to price increases.

In parallel, the threat of higher energy prices came back into focus with rising tensions in the Middle East, reminiscent of the significant impact on oil prices following the Russian invasion of Ukraine in February 2022. Yet, while the price of a barrel of WTI oil had climbed by around $30 in response to

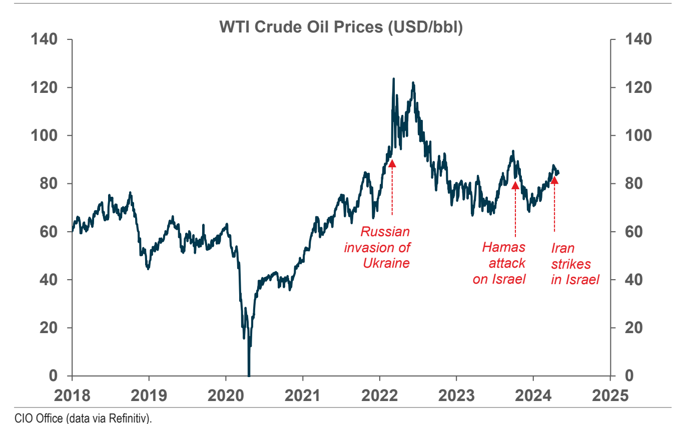
11 | … just as excess savings have run out



CIO Office (data via Refinitiv).

the conflict in Ukraine, the impact on prices of recent events between Israel and Iran is hardly perceptible – for now (**Chart 12**).

12 | Oil prices remain under control



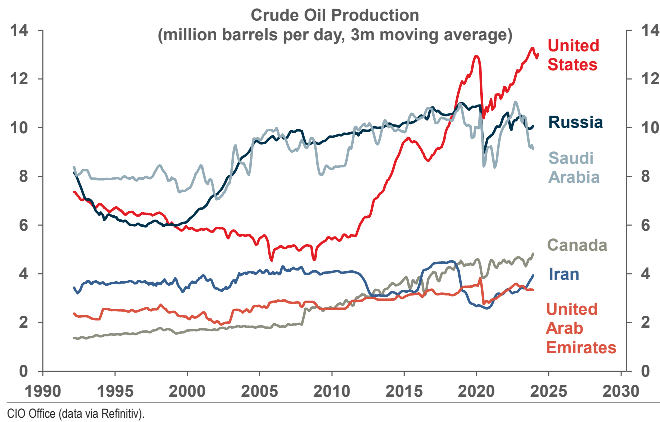
CIO Office (data via Refinitiv).

To put things into perspective, Iran's oil production is around 2.5 times lower than Russia's (**Chart 13**, next page). What's more, with the United States now the world's leading oil producer, and OPEC countries (excluding Iran) possessing spare production capacity greater than what Iran is currently producing[1], the risk of a drastic spike in prices seems relatively limited.

Consequently, the impact of energy prices on annual U.S. CPI growth seems most likely to remain moderate. Alternatively, the worst-case scenario involving a temporary closure of the Strait of Hormuz could see prices rise by around $15,

[1] Source: Goldman Sachs

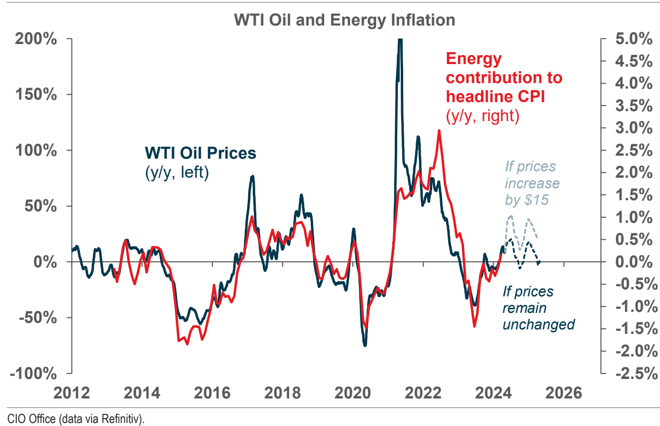
13 | Iran: one oil producer among many



CIO Office (data via Refinitiv).

according to Goldman Sachs' research team. In this case, the impact on annual U.S. CPI would definitely be problematic, but still well below what occurred in 2022 (**Chart 14**).

14 | Energy inflation: this is not 2022

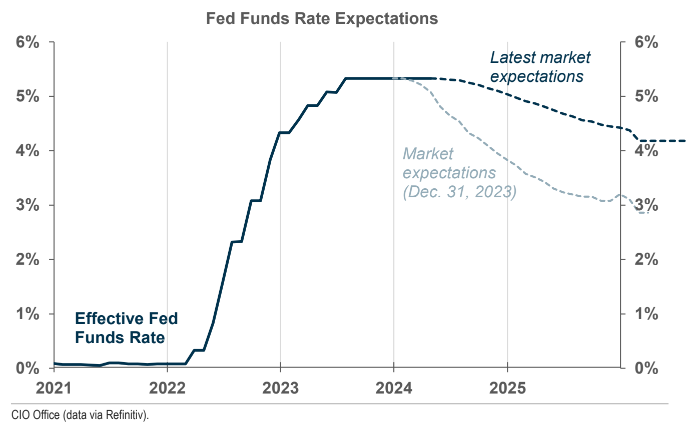


CIO Office (data via Refinitiv).

The Bottom Line

As in a marathon, crossing the last mile separating inflation from its target is the most arduous stage, as the Fed seeks to ensure the perfect level of economic activity to reach its destination... without slipping into recession. Now, with the latest inflationary surprises having pushed back the goal line, markets are expecting only one rate cut in 2024 in the U.S., compared to six at the start of the year (**Chart 15**).

15 | Only one Fed rate cut in 2024?



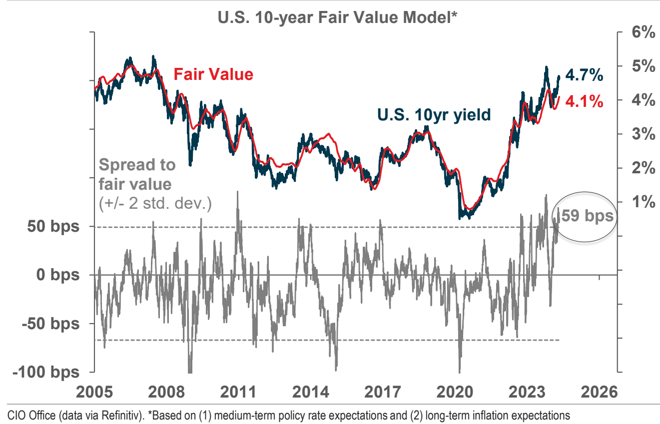
CIO Office (data via Refinitiv).

However, while inflation may continue to surprise for some time yet, for now, the rise in prices seems to be essentially the consequence of lagged effects in the face of a resilient economy – and not the result of an overheating economy requiring higher rates.

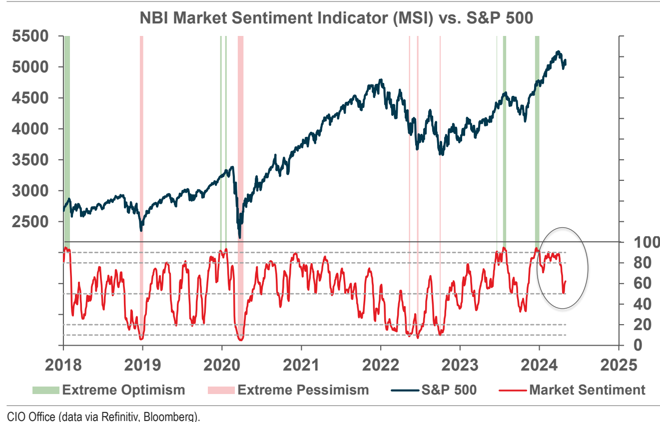
For bond markets, this means that the odds of reference yields continuing their ascent (which are already two standard deviations above their fair value, **Chart 16**, next page) appear limited. However, the absence of rate cuts by the Fed for several months also limits potential gains for the asset class in the immediate future.

On the equities front, more reasonable investor sentiment reduces the risk of larger declines over the coming months although, here too, the prospects of gains appear limited, given the still elevated expectations (**Chart 17**, next page).

16 | Bonds: the rise in 10-year yields looks stretched



17 | Stocks: sentiment no longer so complacent

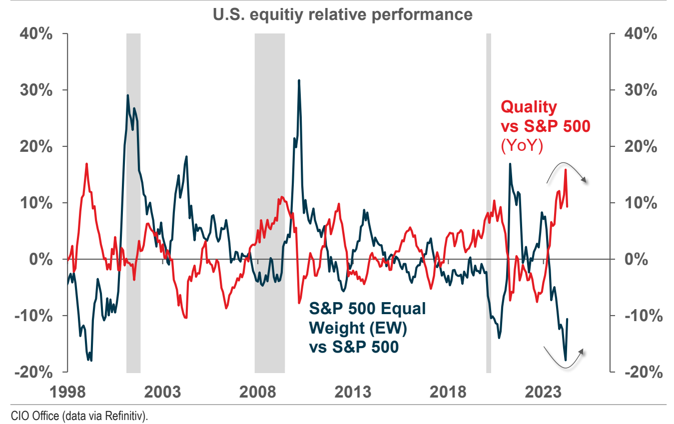


In short, with bond and stock markets expected to be volatile but trendless, we are maintaining our balanced allocation between equities and bonds. However, within equities, we are adding a value bias in two ways and for two main reasons.

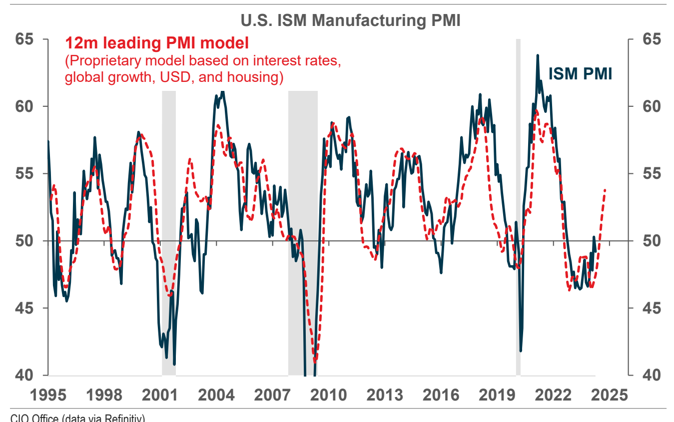
Firstly, after an historic outperformance of the quality factor (which we have been favouring since July 2022 in the U.S.), it was time to book profits, as a reversion to the mean could lead to a catch-up of the S&P 500 Equal Weight (a strategy negatively correlated to the quality factor and closely linked to the value factor, **Chart 18**).

Secondly, although the economic situation remains fragile, a pick-up in manufacturing activity (as indicated by our leading model, **Chart 19**) could be the trigger for this rotation. With the exception of the tech bubble of the late 1990s, an upturn in the ISM PMI Indicator has almost always led to more broad-based leadership in equities (**Chart 20**).

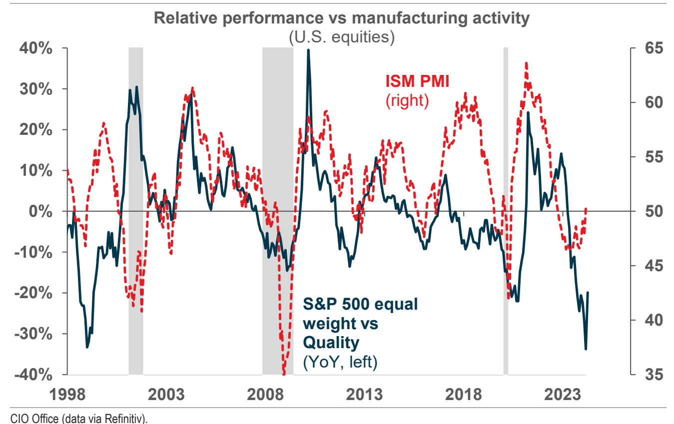
18 | After a quality rally, EW could spring back...



19 | ... with a manufacturing recovery...



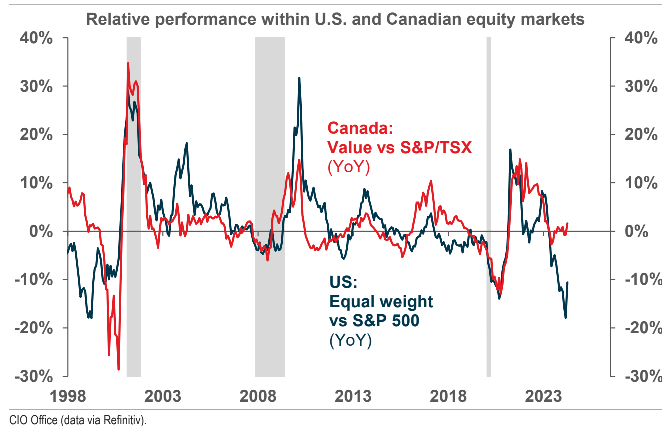
20 | ... acting as a trigger



In Canada, the same phenomenon tends to occur with the value factor, which moves in close

proximity to the relative performance of the equally-weighted S&P 500 (**Chart 21**).

21 | Two closely linked strategies



Besides, it's worth noting that the probability of success is generally higher with the value style in Canada than in the U.S. in all cases and scenarios. This is why we generally avoid traditional value strategies south of the border, opting instead for positions in the Equal Weight Index, which has a better track record (**Chart 22**, next page).

22 | Canadian value ≠ U.S. value

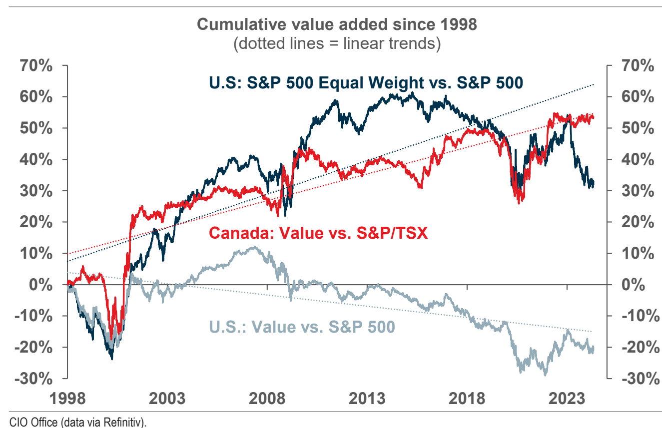


Table 3 Global Asset Allocation - Model Portfolio Weights (in CAD)

	Benchmark		Model Portfolio				Comments
			Total		Asset Class		
	Total	Asset Class	Allocation	Active Weight	Allocation	Active Weight	
Asset Classes							
Cash	0%	-	0.0%	0.0%	-	-	While recession risks remain high over a one-year horizon, the Fed's pivot could continue to support equity markets in the short term. Overall, this context argues for a balanced strategy across asset classes. Alternatives allow for better control of the total risk of the portfolio through their diversification effects.
Fixed Income	40%	-	38.0%	-2.0%	-	-	
Equities	60%	-	59.0%	-1.0%	-	-	
Alternatives	0%	-	3.0%	3.0%	-	-	
Fixed Income							
Government	29%	74%	28.3%	-1.1%	75%	0.9%	With lower inflation and rate cuts approaching, long-term yields are likely to decline, especially if the economic slowdown becomes more pronounced. This environment justifies a slightly longer duration, with credit exposure close to the benchmark.
Investment Grade	11%	26%	9.7%	-0.9%	25%	-0.9%	
High Yield	0%	0%	0.0%	0.0%	0%	0.0%	
Duration	*7.1 yrs*	-	*8.1 yrs*	1.0 yrs	-	-	
Equities							
Canada	21%	35%	19.0%	-2.0%	32%	-2.8%	Macro conditions and momentum are undermining the outlook for emerging markets and Canada compared to the U.S. and EAFE. In the U.S., the Equal Weight Index offers better upside potential should manufacturing recover, as does the value style in Canada. The strategy remains prudent, however, with a mix of stable-dividend, high-quality, and Japanese equities (in yen).
United States	21%	35%	24.0%	3.0%	41%	5.7%	
EAFE	12%	20%	13.0%	1.0%	22%	2.0%	
Emerging markets	6%	10%	3.0%	-3.0%	5%	-4.9%	
Alternatives							
Inflation Protection	0%	0%	0.0%	0.0%	0%	0.0%	A systematic quantitative strategy that takes advantage of market trends while aiming for maximum decorrelation with equities and tight control of volatility (NALT) plays an important role as a diversifier, while offering exposure to high risk-free rates.
Gold	0%	0%	0.0%	0.0%	0%	0.0%	
Non-Traditional FI	0%	0%	0.0%	0.0%	0%	0.0%	
Uncorrelated Strategies	0%	0%	3.0%	3.0%	100%	100.0%	
Foreign Exchange							
Canadian Dollar	61%	-	57.0%	-4.0%	-	-	The overall portfolio strategy involves an overweight in the US dollar and the yen. This positioning reflects the geographic allocation within equities, as well as a willingness to underweight the Canadian dollar against safe-haven currencies in an uncertain global economic context, and a more challenging one in Canada.
U.S. Dollar	21%	-	27.0%	6.0%	-	-	
Euro	5%	-	3.8%	-0.8%	-	-	
Japanese Yen	3%	-	5.5%	2.5%	-	-	
British Pound	2%	-	1.4%	-0.3%	-	-	
Others	9%	-	5.3%	-3.5%	-	-	

CIO Office. The fixed income benchmark is 100% FTSE Canada Universe. There are no alternative assets in the benchmark as their inclusion is conditional on improving the risk/return properties of traditional assets (60/40). The amplitude of the colour bars under the "Active Weight" columns are proportional to the maximum deviations of the portfolio (+/- 10% for stocks and bonds, +10% in cash, +20% in alternative assets).

CIO Office
CIO-Office@nbc.ca

Martin Lefebvre
Chief Investment Officer
martin.lefebvre@nbc.ca

Louis Lajoie
Director
Investment Strategy
louis.lajoie@nbc.ca

Simon-Carl Dunberry
Director
Portfolio Strategy
simon-carl.dunberry@nbc.ca

Nicolas Charlton
Associate
Quantitative Strategy
nicolas.charlton@nbc.ca

Mikhael Deutsch-Heng
Associate
Investment Strategy
mikhael.deutschheng@nbc.ca

Zaid Shoufan
Associate
Portfolio Strategy
zaid.shoufan@nbc.ca

Julien Gordon
Analyst
Quantitative Strategy
julien.gordon@nbc.ca

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