ASSET ALLOCATION STRATEGY

June 2020

Are Markets Disconnected from Reality?

Highlights

- After spending most of May consolidating near the 50% retracement level, risk assets climbed higher at the end of the month. As a result, Wall Street's flagship Equity Index now stands at the same level as it was… just 7 months ago. Meanwhile on Main Street, recent labour reports showed total employment back to where it was… 23 years ago.
- Such a dichotomy between financial markets and the underlying economy has inevitably (and understandably) aroused scepticism among many investors. Yet, the divergence between Wall Street and Main Street doesn't appear to be the result of extreme exaggeration on the part of speculators. Instead, it comes from an extreme example of the fundamental differences in their underlying characteristics and drivers, that is the fact that (1) equity markets are discounting machines, (2) discount rates have dropped significantly, and (3) the U.S. stock market is dominated by sectors better equipped to face this crisis. Therefore, we continue to believe that it would be misguided to adopt an outright defensive asset allocation in the current context.
- That said, there are good reasons to question the potential for positive surprises in the short term, given that the scenario discounted by the markets is already among the most optimistic. To be clear, it may well be that the economy quickly picks up without permanent damage while the race for a vaccine against COVID-19 bears fruit – in which case stocks will continue to trend upward without much hassle. However, the potential pitfalls appear too numerous and the asymmetry of outcomes too unbalanced to justify a tactical increase in risk at these levels. Therefore, we remain cautious by maintaining our overweight allocation to cash, underweight to fixed income and neutral to equities stances. We also hold our bias towards the U.S. equity market and our underweight in the EAFE region.
- Are negative interest rates coming to North America? Not under current circumstances, as monetary measures in place have already put a floor on inflation expectations, capped the USD, and allowed credit to flow. It would therefore be surprising to see government bond yields – which remain significantly overbought – venture much lower.
- Will *value* & *cyclical* stocks outperform their *growth & defensive* peers over the coming months? That's not what we expect for now. Beyond the inevitable bounce back of many economic indicators, the recovery in global growth is likely to be only gradual and will remain highly fragile until a vaccine becomes available. In addition, one of the key drivers of cyclical leadership is the direction of interest rates, who's upside is capped by central banks' "unlimited" quantitative easing.
- Considering the ongoing rationalization amongst U.S. producers, recently announced additional cuts from Saudi Arabia due to come into force on June 1, as well as a tentatively improving demand-side picture with much of the developed world having begun to ease lockdown measures, crude oil supply-and-demand fundamentals are now much clearer. Nevertheless, the picture remains far from rosy for oil markets. And, while we are unlikely to revisit April lows, until such time as demand can more than offset supply and eat into existing inventory levels, prices are unlikely to move much higher.

Table 1 **Global Asset Allocation**

Global Classes	−	Weights			+
Cash				■	
Fixed Income		■			
Equities			■		
Fixed Income					
Federal		■			
Investment Grade				■	
High Yield (USD)		■			
Non-Traditional FI				■	
World Equities					
S&P/TSX			■		
S&P 500 (USD)				■	
MSCI EAFE (USD)		■			
MSCI EM (USD)			■		
Factors and Alternative Investments					
Value vs. Growth			■		
Small vs. Large			■		
Low Vol. vs. High Beta			■		
Canadian Dollar			■		
Commodities			■		
Energy			■		
Base Metals			■		
Gold				■	
Infrastructure			■		

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Current Allocation ■

Previous Allocation

Market Review

Fixed Income

- The U.S. 10-year treasury yield remained flat throughout May, kept in place by steady market-implied inflation and growth expectations.
- Higher up the credit ladder, a flattening of investment grade (down 30 bps) and high yield (down 86 bps) spreads helped these assets outperform their safer counterparts.
- In Canada, it was a relatively quiet month for the asset class, with yield curve and credit spreads range-bound throughout the period.

Canadian Equities

- Range-bound was a common theme for many asset classes in May, with Canadian equities no exception.
- A string of less-worse-than-expected economic data later in the month ultimately helped lift the index higher and close out in the positive for a second month in a row.
- Healthcare and Information Technology led the way, earning double-digit growth, while the more bond-like Utilities and Real Estate sectors lagged.

U.S. Equities

- Also range-bound for most of May, the S&P 500 did close out the month above its 200-day moving average, a first since the start of the crisis.
- While much uncertainty remains regarding the path COVID-19 cases will take in the weeks to come, the beginnings of an abatement in lockdown measures provided investors with hope that consumer demand could soon recover.
- The cyclical Materials and Industrials sectors closed out the month at the head of the pack, while the more defensive Consumer Staples and hard-hit Energy sectors both lagged.

Commodities

- Following April's historic descent into negative price territory, Crude Oil markets looked to be on a path of normalization in May.
- U.S. shut-ins and OPEC+ supply cuts, as well as rising demand following an easing of lockdown measures helped shift the supply-and-demand needle away from a position of extreme oversupply.
- As such, WTI soared last month, posting its strongest monthly performance on record, but still remains near levels last seen in 2016.
- As for Gold, stable real rates and risk sentiment kept the lustrous metal's price action relatively subdued over the period, finishing up by just 1.6%.

Foreign Exchange

- The U.S. Dollar Index crossed a key support threshold late last month, breaking below its two-month-long trading range for the first time as investor sentiment improved.
- As for the Loonie, it too remained within a narrow trading band throughout the month.

Table 2 Market Total Returns

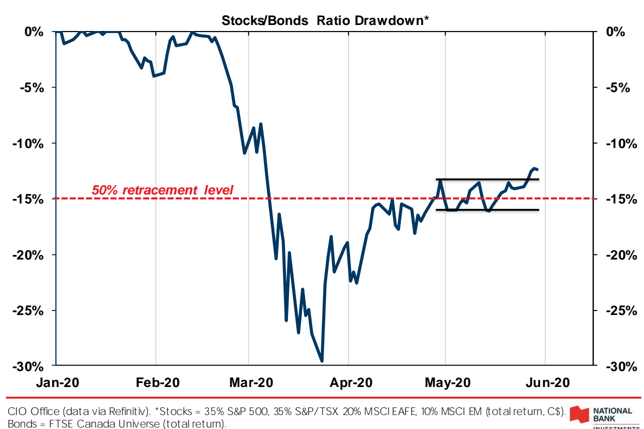
Asset Classes	May	YTD	12 months
Cash (3-month T-bills)	0.1%	0.8%	1.7%
Bonds (FTSE CA Ovr. Univ.)	**0.3%**	**5.7%**	**7.1%**
FTSE CA Short term	0.3%	3.5%	4.1%
FTSE CA Mid term	0.4%	7.2%	7.6%
FTSE CA Long term	0.3%	7.6%	10.5%
FTSE CA Government	0.2%	6.9%	7.8%
Federal	0.2%	7.0%	7.0%
Provincial	0.2%	6.8%	8.6%
Municipal	0.2%	6.0%	7.9%
FTSE CA Corporate	0.6%	2.8%	5.0%
AA+	0.3%	3.4%	4.5%
BBB	1.0%	2.1%	4.7%
BoAML Inv. Grade ($US)	1.7%	2.8%	9.6%
BoAML High-Yield (USD)	4.6%	-5.7%	0.3%
Preferred Shares	-1.7%	-14.5%	-10.0%
Canadian Equities (S&P/TSX)	**3.0%**	**-9.7%**	**-2.1%**
Energy	3.0%	-27.0%	-22.2%
Industrials	2.3%	-5.3%	-0.2%
Financials	0.6%	-19.2%	-11.8%
Materials	2.2%	10.4%	35.0%
Utilities	0.6%	-1.0%	12.6%
Cons. Disc	8.3%	-12.5%	-6.3%
Cons. Staples	4.7%	1.7%	1.6%
Healthcare	5.6%	-28.5%	-51.4%
IT	14.6%	42.7%	68.3%
Comm. Svc.	1.9%	-6.7%	-5.1%
REITs	0.2%	-22.5%	-17.2%
S&P/TSX Small Cap	4.8%	-18.9%	-11.2%
US Equities (S&P500 USD)	**4.8%**	**-5.0%**	**12.8%**
Energy	1.9%	-34.5%	-29.2%
Industrials	5.5%	-16.3%	-3.8%
Financials	2.7%	-23.4%	-7.8%
Materials	7.0%	-8.9%	8.1%
Utilities	4.4%	-6.8%	6.1%
Cons. Disc	5.0%	2.1%	15.6%
Cons. Staples	1.5%	-5.3%	9.4%
Healthcare	3.3%	1.6%	21.1%
IT	7.1%	7.3%	38.4%
Comm. Svc.	6.0%	0.2%	16.4%
REITs	1.9%	-9.9%	-1.7%
Russell 2000 (USD)	6.4%	-16.4%	-4.9%
World Eq. (MSCI ACWI)	**4.4%**	**-8.9%**	**6.0%**
MSCI EAFE (USD)	4.4%	-14.0%	-2.4%
MSCI EM (USD)	0.8%	-15.9%	-4.0%
Commodities (CRB index)	**3.9%**	**-8.6%**	**-11.7%**
WTI Oil (US$/barrel)	78.9%	-44.8%	-37.0%
Gold (US$/ounce)	1.6%	13.9%	33.2%
Copper (US$/tonne)	3.7%	-13.0%	-7.8%
Forex (DXY - US Dollar index)	**-0.7%**	**2.0%**	**0.6%**
USD per EUR	1.6%	-0.9%	-0.2%
CAD per USD	-1.2%	6.0%	1.9%

CIO Office (data via Refinitiv) 2020-05-29

Are Markets Disconnected from Reality?

After spending most of May consolidating near the 50% retracement level, risk assets climbed higher at the end of the month (Chart 1), supported in part by the gradual loosening of lockdown measures and positive developments in the race for a vaccine.

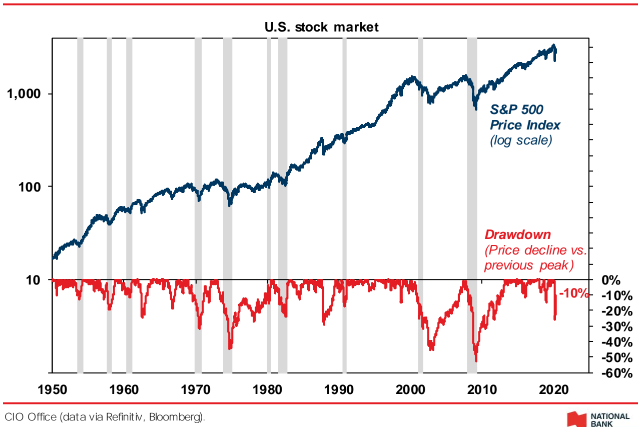
1 After a period of consolidation, the recovery continues



CIO Office (data via Refinitiv). *Stocks = 35% S&P 500, 35% S&P/TSX 20% MSCI EAFE, 10% MSCI EM (total return, C$). Bonds = FTSE Canada Universe (total return).

As a result, Wall Street's flagship Equity Index – the S&P 500 – now stands a mere 10% below its pre-crisis peak; that is roughly the same level as it was… just 7 months ago (Chart 2).

2 **Is Wall Street…**

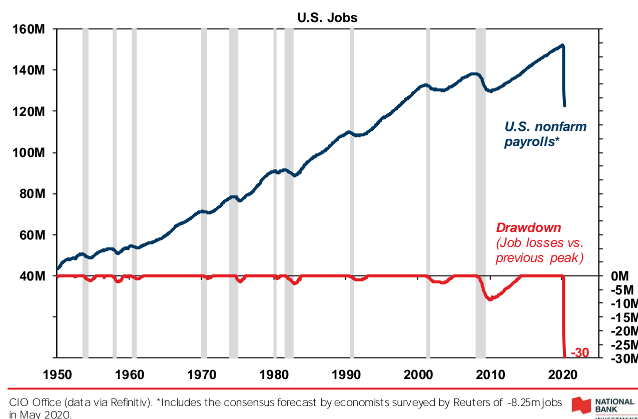


CIO Office (data via Refinitiv, Bloomberg).

Meanwhile on Main Street, recent labour reports have revealed the scope of the crisis for workers. An unprecedented ~30[1] million job losses in the U.S. over the past months brings the total employment figure back to where it was… 23 years ago (Chart 3).

Such a dichotomy between financial markets and the underlying economy has inevitably (and understandably) aroused scepticism among many investors over the sustainability of the stock market rebound. Yet, before jumping to conclusions, let us highlight three elements that help put recent market behaviour into perspective.

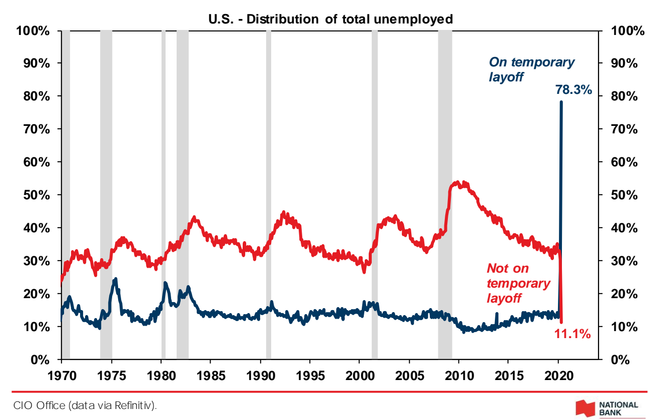
3 …completely disconnected from Main Street?



CIO Office (data via Refinitiv). *Includes the consensus forecast by economists surveyed by Reuters of -8.25m jobs in May 2020.

<u>First, equity markets are discounting machines.</u> While economic data such as job reports provide a picture of current economic growth, the stock market only uses this information as an input to calibrate its expectations about future growth. In "normal" times, heavy job losses portend further job losses, as was the case throughout the 2008/2009 recession, for example. However, the current recession differs significantly in the sense that nearly 8 out of 10 unemployed workers are on temporary layoff (Chart 4). It will unquestionably take much longer to get all of those jobs back than it took to lose them, but the bottom is imminent and that's what matters most for markets.

4 Most unemployed workers are on temporary layoff

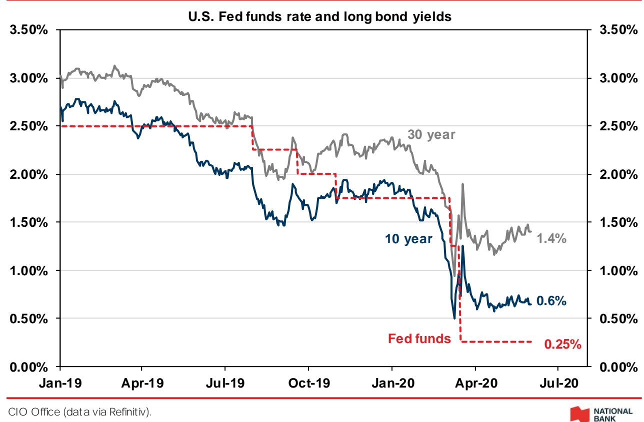


CIO Office (data via Refinitiv).

<u>Second, discount rates prevailing in financial markets have dropped significantly as a result of central bank interventions.</u> By lowering its target rate by 150 bps and most importantly signalling its intention to remain at that level for an extended period (Chart 5, next page), the Federal Reserve has *de facto* increased the present value of future growth (all else being equal). In addition, the massive injection of liquidity has revealed the unsuspected scale and effectiveness of the monetary arsenal available in times of crisis, a precedent that undeniably supports investors' risk appetite.

[1] Includes the consensus forecast by economists surveyed by Reuters of -8.25m jobs in May 2020.

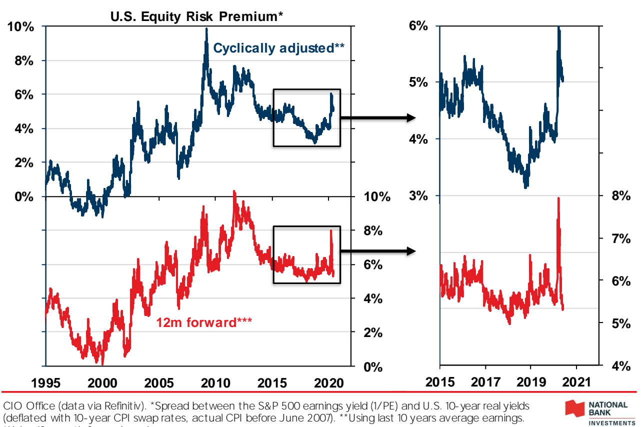
5 Discount rates have dropped significantly...



CIO Office (data via Refinitiv).

Has abundant monetary accommodation pushed market valuations to unreasonable levels? To be sure, we look at the equity risk premium (ERP) which values equities relative to government bond yields. Conclusion: the ERP calculated with 12-month forward earnings is roughly back to where it was for most of the last 5 years, while the cyclically adjusted version is actually in the upper range of its recent history (Chart 6). To put it simply, stock markets are clearly not the bargain they were at the end of March, but risk premiums are not indicative of *irrational exuberance*.[2]

6 ... and equity valuations are not exuberant



CIO Office (data via Refinitiv). *Spread between the S&P 500 earnings yield (1/PE) and U.S. 10-year real yields (deflated with 10-year CPI swap rates, actual CPI before June 2007). **Using last 10 years average earnings. *Using 12-month forward earnings.

<u>Third, the U.S. stock market is not a perfect reflection of the U.S. economy.</u> Like any crisis, there are sectors of the economy that fare better than others. It turns out that this time, it is mainly companies in the technology (26% of the S&P 500), healthcare (15%), and communication service sectors (11%) that are better equipped, the top three sectors of the U.S. equity market. Contrary to what one might think, even the fourth-biggest sector (consumer discretionary) is doing rather well, but let's not forget that it is dominated by Amazon, not mom-and-pop stores. On the other hand, sectors most directly linked to overall economic growth (Financials, Industrials, Energy) are still posting heavy losses this year (Chart 7).

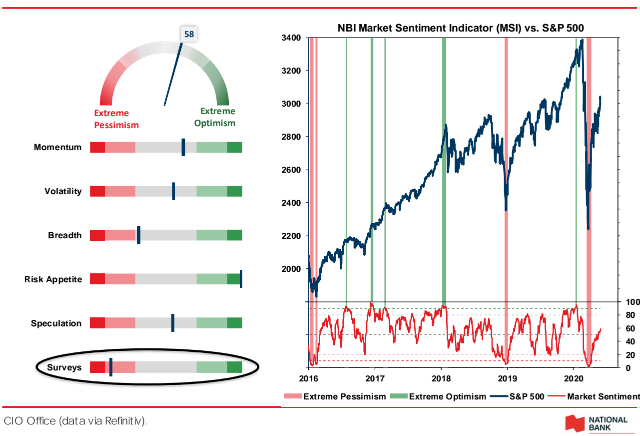
7 The S&P 500's sector allocation tells the story

U.S. Equities	Weight	Performance (price) Last week	MTD	YTD	1-YR
S&P 500		3.0%	4.5%	-5.8%	9.4%
Technology	26%	1.4%	6.8%	6.7%	35.2%
Health Care	15%	3.4%	3.1%	0.8%	18.7%
Comm. services	11%	0.6%	6.0%	-0.4%	12.5%
Discretionary	11%	2.0%	4.9%	1.6%	13.0%
Financials	10%	6.6%	2.4%	-24.2%	-11.7%
Industrials	8%	6.0%	5.1%	-17.1%	-6.7%
Staples	7%	3.0%	1.4%	-6.4%	5.1%
Utilities	3%	5.7%	3.9%	-8.0%	3.1%
Energy	3%	0.9%	0.7%	-36.1%	-34.4%
Real Estate	3%	5.8%	1.7%	-10.8%	-3.4%
Materials	3%	4.7%	6.7%	-9.7%	4.6%

CIO Office (data via Refinitiv). As of May 29, 2020.

In summary, the point is that the divergence between Wall Street and Main Street doesn't appear to be the result of extreme exaggeration on the part of investors and speculators. Case in point, our sentiment indicator remains far from a level of exaggeration, while the survey sub-component still leans on the side of pessimism (Chart 8). Instead, it arguably comes from an extreme example of the fundamental differences in their underlying characteristics and drivers.

8 Sentiment remains far from a level of exaggeration



CIO Office (data via Refinitiv).

What's more, when we look at other periods of similar stock market rises, we see that they tend to bode well for the medium to long-term outlook – , not the other way around (Chart 9, next page). As such we continue to believe that it would be misguided to adopt an outright defensive asset allocation in the current context. This is especially true now that markets have gone through a period of consolidation and oil fundamentals have improved (see commodities section), officially bringing all items on our list to green (Chart 10, next page).

[2] "Irrational exuberance" is the phrase used by the then-Federal Reserve Board chairman, Alan Greenspan, in a speech given at the American Enterprise Institute during the dot-com bubble of the 1990s. The phrase was interpreted as a warning that the stock market might be overvalued. (from Wikipedia)

9 What goes up doesn't always have to come down

S&P 500 Total Return Index (since 1973)

10 Best Quarters	Performance	Following Quarter	Following Year	Following 3 Years (Annualized)	Following 5 Years (Annualized)
Q1 1975	23.9%	14.4%	25.7%	5.4%	6.9%
Q4 1998	23.6%	5.6%	24.3%	1.5%	1.1%
Q1 1987	21.2%	4.8%	-9.5%	8.5%	12.2%
Q4 1982	19.9%	9.0%	20.9%	19.3%	15.9%
Q2 1997	19.1%	7.7%	32.4%	22.9%	6.1%
Q4 1985	18.4%	15.2%	18.2%	12.5%	13.4%
Q4 1999	17.1%	4.2%	-5.7%	-12.9%	-1.3%
Q1 1991	16.9%	0.3%	16.2%	11.1%	16.5%
Q2 2009	15.8%	15.3%	13.9%	16.2%	18.6%
Q2 2003	15.4%	2.7%	19.1%	11.0%	7.3%
Quarter-to-date*	18.2%	?	?	?	?
Average	19.1%	7.9%	15.6%	9.5%	9.7%
Positive / Total	-	10/10	8/10	9/10	9/10

CIO Office (data via Refinitiv). *From March 31 to May 29, 2020.

10 Cyclically ready, tactically wary

- ✓ Concrete fiscal measures to help workers and businesses
- ✓ The flow of credit to be restored to households and businesses
- ✓ The stock market to consolidate around current levels
- ✓ A slowdown in the growth rate of new COVID-19 cases worldwide
- ✓ Clearer crude oil supply-and-demand fundamentals

CIO Office.

That said, there are good reasons to question the potential for positive surprises in the short term, given that the scenario discounted by markets is already among the most optimistic. To be clear, it may well be that the economy quickly picks up without permanent damage while the race for a vaccine against COVID-19 bears fruit – in which case stocks will continue to trend upward without much hassle. However, the potential pitfalls appear too numerous and the asymmetry of outcomes too unbalanced to justify a tactical increase in risk at these levels. Therefore, we remain cautious by maintaining our overweight allocation to cash, underweight to fixed income and neutral to equities stance. We also hold our bias towards the U.S. equity market and our underweight in the EAFE region.

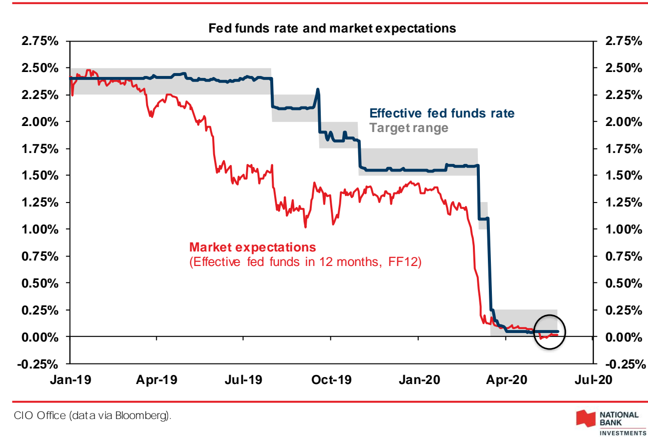
Fixed Income: Monetary Arsenal

As we have just described, central bank intervention has been one of the key factors behind the market rebound. Nevertheless, the debate over their ability to do more in the event of further economic weakness persists. Asked about this, Jerome Powell was very clear:

> *We're not out of ammunition by a long shot. No, there's really no limit to what we can do with these lending programs that we have. So there's a lot more we can do to support the economy, and we're committed to doing everything we can as long as we need to.*
>
> *- Jerome Powell, CBS 60 Minutes Interview, May 17, 2020*

Such reassuring remarks from the President of the Federal Reserve should come as no surprise. After all, the choice of words is a key part of any central bank's monetary policy toolbox, as the slightest lack of clarity can quickly offset the benefits of any other measure. What was more surprising earlier in May is the fact that interest rate derivative market participants began to discount the possibility that the Federal Reserve would use another (and rather controversial) tool: a negative interest rate policy (NIRP) (Chart 11).

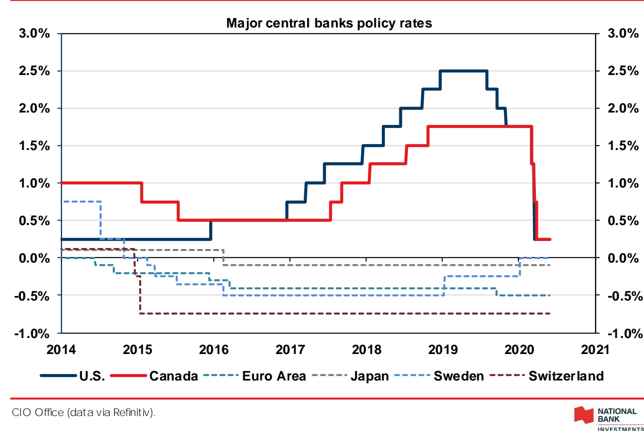
11 Are negative interest rates coming to the U.S....



CIO Office (data via Bloomberg).

NIRP has been a subject of much debate amongst economists since the Euro Area, Switzerland, Sweden and Japan all went down that path between 2014 and 2016 (Chart 12). Our objective is certainly not to enter into this argument, but rather to assess whether it is a likely scenario given that it would have implications for nearly all financial assets.

12 ... as elsewhere in Europe and Japan?



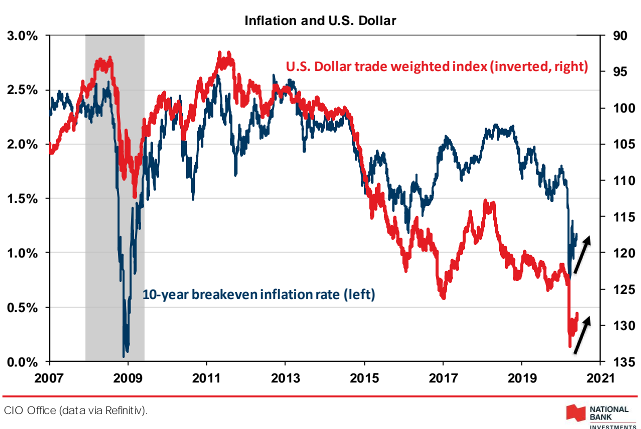
CIO Office (data via Refinitiv).

In its simplest terms, cutting a policy rate into negative territory is an act of last resort made by cental banks to fight the risk of deflation by supporting credit growth and weakening the currency. On the other hand, this also tends to cause several

adverse side effects, such as to weaken the banking sector. So, do current conditions call for such a controversial move?

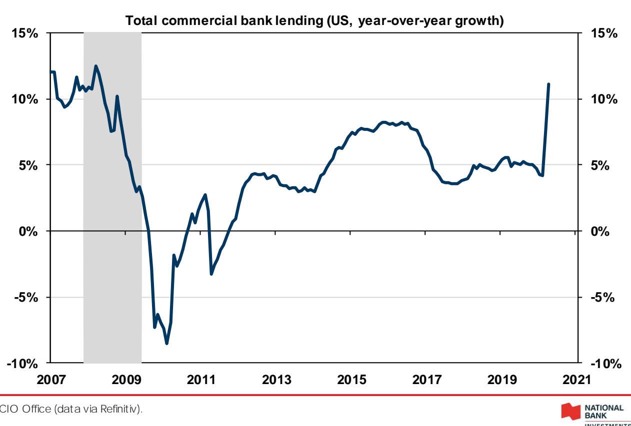
No. Monetary measures in place have already put a floor on inflation expectations, capped the USD (Chart 13), and allowed credit to flow (Chart 14). If these trends continue along with economic activity recovering as we expect, then there is absolutely no reason to anticipate negative rates south of the border.

13 Inflation expectations, the U.S. dollar…



CIO Office (data via Refinitiv).

14 … and credit growth do not call for NIRP



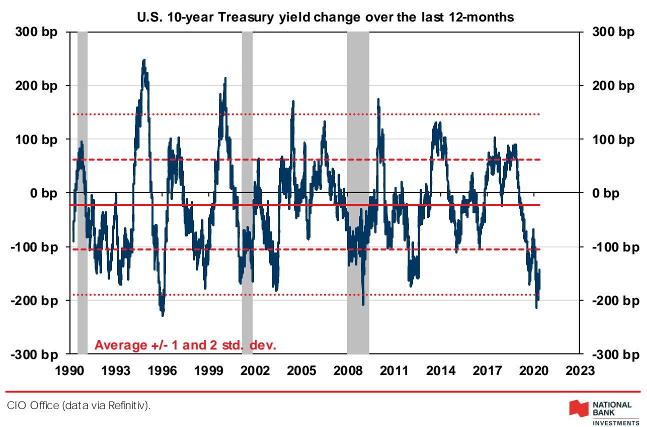
CIO Office (data via Refinitiv).

Moreover, there is little doubt that the Fed will use other measures (such as further asset purchases and/or an explicit control on the yield curve[3]) before even considering moving the target rate below zero. Once again, Jerome Powell has been quite clear on this subject recently:

> *I continue to think, and my colleagues on the Federal Open Market Committee continue to think, that negative interest rates is probably not an appropriate or useful policy for us here in the United States.*
>
> *There's no clear finding that it actually does support economic activity on net, and it introduces distortions into the financial system, which I think offset that.*
>
> *There're plenty of people who think negative interest rates are a good policy. But we don't really think so at the Federal Reserve.*
>
> *- Jerome Powell, CBS 60 Minutes Interview, May 17, 2020*

In short, it appears that the rising market-implied odds of negative interest rates which we momentarily observed in May were mostly a reflection of market technicalities.[4] It would therefore be surprising to see government bond yields – which remain significantly overbought (Chart 15) – venture much lower. On the other hand, central banks' "unlimited" quantitative easing limits the risk of a sharp rise in bond yields. Consequently, the last few months of relative stability for Treasury yields are probably a good indication of what to expect in the near future, with recovering inflation expectations likely to exert only modest pressure to the upside.

15 Government bond yields remain significantly overbought



CIO Office (data via Refinitiv).

Equities: Brutal**… but Brief** Rotation?

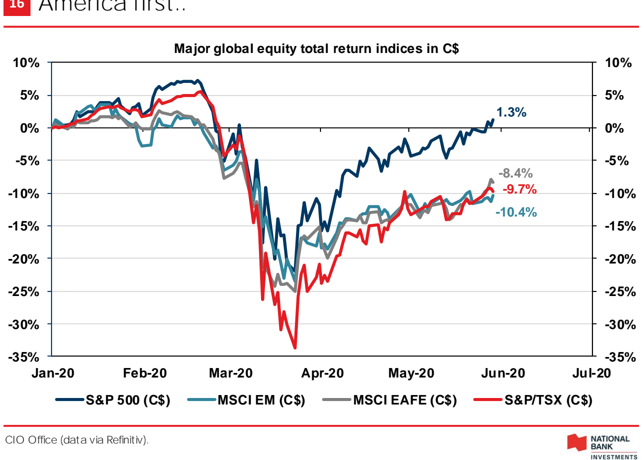
Another month of gains for equities, as the S&P 500 4.3% May advance (in C$) officially puts the stock market index in positive territory year-to-date from a Canadian investor point of view. This places the U.S. well ahead of their peers over the period (Chart 16, next page).

As we have mentioned, on many occasions (including in the introduction of this report), it is the U.S. market sector allocation that makes all the difference in the current environment. For instance, if we group sector weights into two main families – *growth & defensive* vs. *value & cyclical* – and compare the S&P 500 to the S&P/TSX, we can see how fundamentally different the two indices are, despite their geographical proximity. The U.S. market is substantially overweight in *growth & defensive* (main beneficiaries of a low-rate environment)

[3] Fed's Williams: Economy May Be Bottoming As Fed Weighs Yield-Curve Control, Wall Street Journal, May 27, 2020.

[4] How bank hedging jolted investors into talk of negative rates. Financial Times, May 14, 2020.

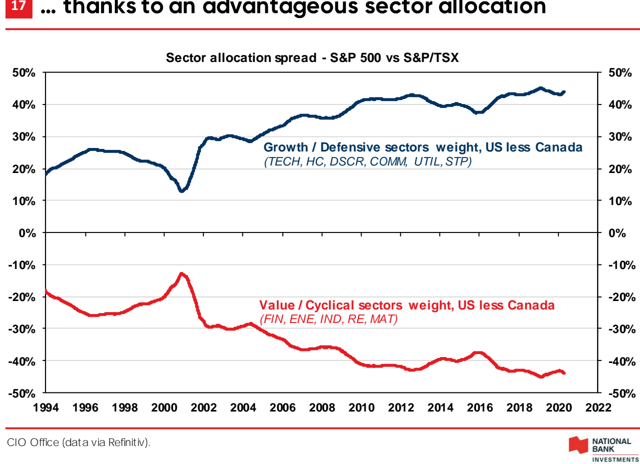
16 America first..



CIO Office (data via Refinitiv).

sectors relative to Canada, dominated by *value & cyclical* names (most impacted by weak global growth) (Chart 17).

17 … thanks to an advantageous sector allocation



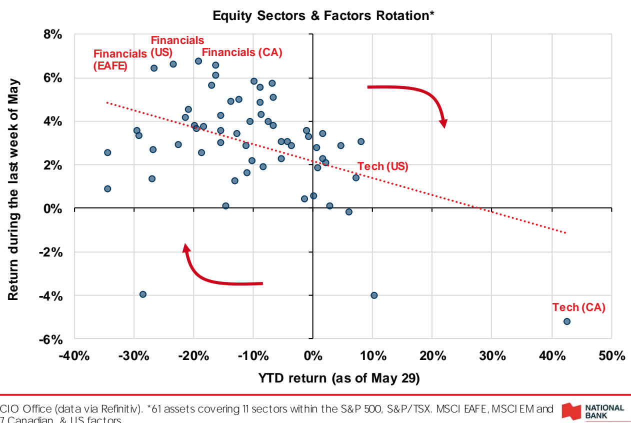
CIO Office (data via Refinitiv).

However, an especially brutal rotation in favour of sectors/factors lagging far behind in 2020, such as the highly cyclical financials, was observed at the end of May (Chart 18). Is this the beginning of a sustained rotation in favour of sectors more directly linked to global growth? Or, is it simply yet another head fake?

For now, we believe it is still too early to expect an environment conducive to cyclical outperformance. Granted, most economic indicators will naturally rebound from their depressed levels over the summer and autumn, as we started to see in China, the first economy to experience "deconfinement" (Chart 19).

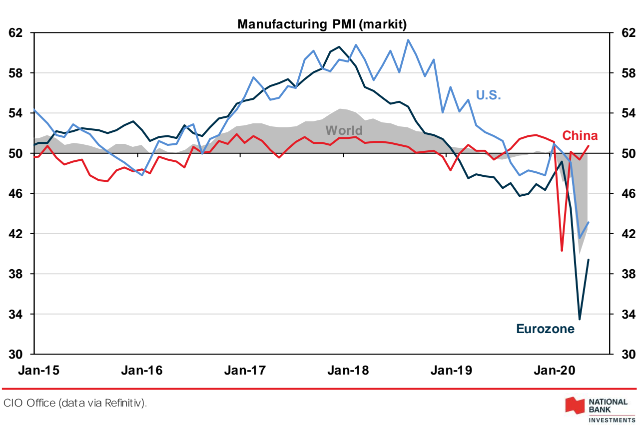
But beyond the inevitable bounce back, the recovery in global economic activity is likely to be only gradual and will remain highly fragile until a vaccine becomes available. In addition, one of the key drivers of cyclical leadership is the direction of interest rates. As we argued in the fixed-income section, bond yields are likely to remain relatively low for several months, limiting the potential for sustained rotation into cyclicality (Chart 20).

18 Brutal… but brief rotation?



CIO Office (data via Refinitiv). *61 assets covering 11 sectors within the S&P 500, S&P/TSX, MSCI EAFE, MSCI EM and 7 Canadian & US factors.

19 Economic indicators will "naturally" rebound…



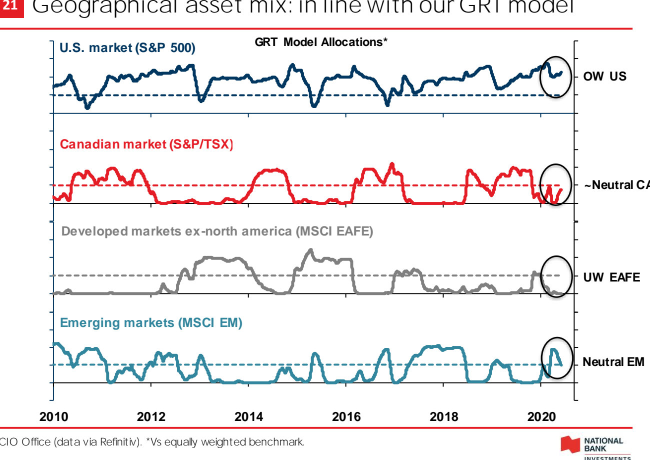
CIO Office (data via Refinitiv).

20 … but what happens next for cyclical sectors is unclear

CIO Office (data via Refinitiv). *Ratio between average of S&P 500 Value & Cyclical sectors (Financials, Energy, Materials, Cons. Discr., Industrials, Real Estate) and Growth & Defensive sectors (Tech, Health care, Comm svs, Utilities, Staples)

Against this background, we are maintaining our overweight allocation to U.S. equities at the expense of the EAFE region. We remain neutral in emerging markets and Canadian equities, so that our overall positioning is very close to our GRT model recommendations (Chart 21, next page).

21 Geographical asset mix: in line with our GRT model

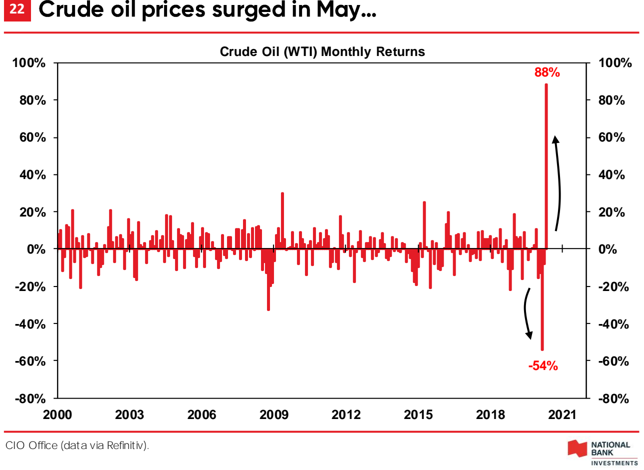


CIO Office (data via Refinitiv). *Vs equally weighted benchmark.

Commodities: Toward Normalization

Crude oil prices surged in May (Chart 22), while implied volatility on the commodity fell closer to its pre-crisis levels (Chart 23). The positive shift comes just a month following the WTI's historic plunge into negative price territory. But, does that mean that everything is already back to normal?

22 **Crude oil prices surged in May...**

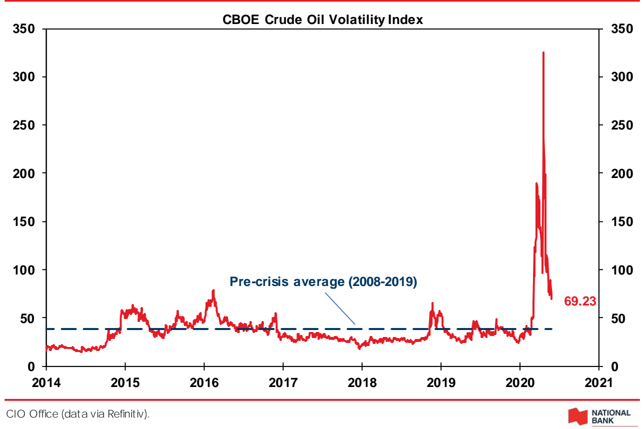


CIO Office (data via Refinitiv).

Considering (1) the ongoing rationalization amongst U.S. producers (Chart 24), (2) recently announced additional cuts from Saudi Arabia due to come into force on June 1, as well as (3) a tentatively improving demand-side picture with much of the developed world having begun to ease lockdown measures last month, crude oil supply-and-demand fundamentals are now undoubtedly clearer. These improvements were also reflected in the most recent report from the International Energy Agency (IEA) dated May 14, which highlighted "massive cuts in output from countries outside the OPEC+ agreement and faster than expected."[5]

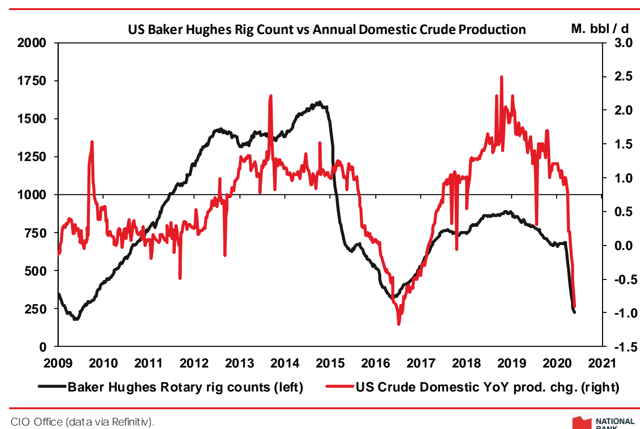
Nevertheless, the picture remains far from rosy for oil markets. For instance, a barrel of WTI hasn't traded at these levels since early 2016 (Chart 25). And, while we are unlikely to revisit April lows, until such time as demand can more than offset supply and eat into existing inventory levels (Chart 26), prices are unlikely to move much higher either.

23 **... as the dust begins to settle**



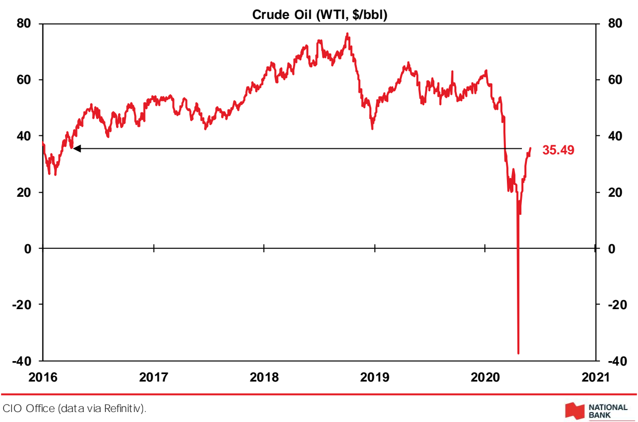
CIO Office (data via Refinitiv).

24 **U.S. production is rationalizing...**



CIO Office (data via Refinitiv).

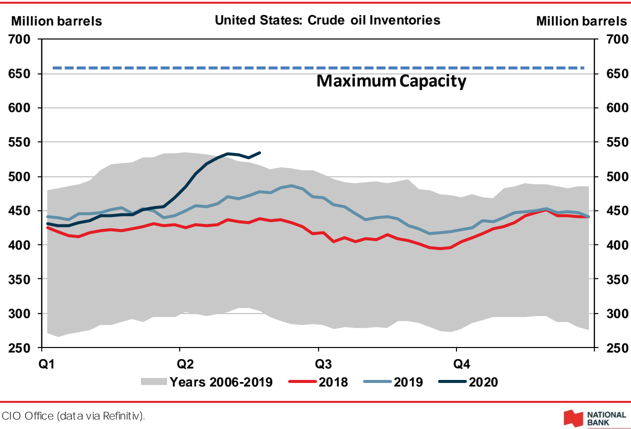
25 **... but prices are likely to remain relatively low...**



CIO Office (data via Refinitiv).

[5] IEA Oil Market Report, May 2020.

26 ... under the weight of significant inventories



CIO Office (data via Refinitiv).

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General

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