ASSET ALLOCATION RECOMMENDATION

April 2, 2019

Current Environment

In the Soft Spot

Markets haven't yet sounded a full recession alarm bell judging by equities, but the fixed income market has turned the table, starting to price in odds of a rate cut rather than further rate hikes in North America. The central banks haven't had quite as much of an epiphany but the Fed is now signaling that it could be on hold for a year, while the Bank of Canada will likely underscore a similar message in its next report.

Both are responding to hints of softness on the domestic front but more notably, a weaker period for the global economy, hitting key export markets in Asia and Europe. While a global boom isn't likely to return, a favourable resolution of trade tensions, fiscal and monetary stimulus in China and a fiscal easing in the E.U. should see overseas economies do a bit better over the balance of 2019.

With housing and consumption softening, Canada saw almost no growth in the final quarter of 2018, with Q1 oil production cuts likely to extend that very sluggish pace into this year. While we expect a recovery in oil production and a pause in rate hikes to allow for better news in Q2 and beyond, growth for this year and 2020 in the 1½% range won't justify a further rate hike but neither should it be soft enough to force the outright ease that the bond market is looking for.

The U.S. has yet to record a quarter below 2%, and while we will see that to start 2019, that's largely due to the one-time drag from a temporary government shutdown. Growth for the year is still projected to be reasonably healthy at 2.2%. Still, with global conditions tame and the Fed, if anything, concerned that inflation expectations will be too low, it could keep rates on hold in 2019. Our growth concerns for the U.S. are more of a 2020 story, when fiscal stimulus runs dry. At that point, growth in the 1½% range could allow the Fed to nudge the funds rate a quarter point lower in a mid-cycle ease.

Keeping Our Bond, Currency Views

While we share the view that North American central banks could be done with rate hikes for this cycle, the rally we've seen in long-term bonds has been generated by excessive pessimism on the global backdrop. If, as we expect, the economic news brightens somewhat over the spring, long yields won't be able to sustain such low levels, at least until we see a more sustained slowing in the U.S. economy and a turn to Fed easing. We are therefore maintaining a lower duration in our bond holdings versus the benchmark.

Corporate spreads remain vulnerable over the medium term as earnings growth slows. While we're not anticipating a recessionary shock or a large jump in defaults, room for a repricing of risk, and therefore wider spreads, has us maintaining an overweight in government bonds.

The Canadian dollar has drifted a bit stronger, in part capturing the decidedly dovish tone taken by the U.S. Fed. While there's a risk of further creeping gains for the loonie, that upside is limited given Canada's weak trade balance and the need to shift growth from domestic sectors like housing towards exports and related capital spending. We also see the recovery in oil prices, another C$ driver, as coming to an end soon. If there's a major move ahead for the currency in the next couple of years, it's therefore likely to be towards a weaker loonie. So while the timing of such a move is highly uncertain, we're retaining our exposure to U.S. dollars in order to capture the resulting C$ returns if it does materialize.

Outlook & Recommended Allocation

After a tumultuous fourth quarter of 2018, the first quarter of 2019 was all "sunshine and rainbows". Virtually all

equity markets rebounded with most developed markets generating double-digit returns. The U.S. generated a return close to 14% and Canada a similar amount. Even a problematic market like the U.K., which still operates under the specter of a possible hard exit from the European Union, produced over 9% in absolute returns in the quarter.

Some of the bounce can certainly be attributed to a particularly bad "close" as poor liquidity hurt year-end pricing. An equally important fundamental factor was a pivot by the U.S. Federal Reserve (and most other central banks) during the quarter. As opposed to concern on rising rates, which weighed on markets towards the end of 2018, the Fed moved to a more accommodative stance both at the short end of the curve and also with respect to its intentions regarding its large holdings of longer-dated Treasuries. These decisions combined to drive interest rates lower with the yield on U.S. 10-year bonds dropping by 25 bps to 2.40% at time of writing. What started as an equity rebound from oversold levels essentially became a full-blooded rally with Central Bank-inspired encouragement.

It is safe to say that virtually all sectors rebounded but leadership came from Information Technology and Energy. In Canada, the Real Estate and Utilities sectors also performed extremely well and Cannabis stocks added some of their own sizzle to the rally. It is worth noting Cannabis stocks are still less than 2% of the S&P/TSX market capitalization but on their own, they added 60 bps to the 13.8% return for the broad benchmark.

Trade concerns also moderated in the quarter, probably overly so. The U.S. and China continue to hold discussions but despite platitudes, progress has been quite limited. President Trump does seem to be more focused on equity returns rather than on fixing structural imbalances, however caution is still warranted.

With the substantial decline in interest rates, returns on bonds now look very meagre. We accept that the more malleable Central Bank tone is on the back of signs of economic weakness in China, the E.U. and even the U.S. The question for investors is how much is already priced in. Earnings estimates for the S&P 500 Index have been cut continually, and the forecast is now only for 4.3% earnings growth in 2019, which seems reasonable to us. Given the rally in bonds and the limited returns on cash, we are upping our recommended exposure to equities slightly. In hindsight, we have been too conservative in our asset mix recommendations. The good news is that tactical decisions during the quarter and strong returns mean that we actually are carrying modestly higher equity weightings in our Canadian Core and North American Yield portfolios.

Exhibit 1: Investment Strategy Committee Targets

	Recent	Q2/2019	Expected Return Q2/2018	Q4/2019	Expected Return Q4/2018
TSX	16,137	16,200	0.39%	16,500	2.25%
S&P 500	2,813	2,800	-0.45%	2,850	1.33%
CANADA					
TSX YIELD (WEIGHTED)	2.64%				
10-YEAR BOND YIELD	1.54%	1.85%	-	2.00%	-
UNITED STATES					
S&P 500 YIELD (WEIGHTED)	1.82%				
10-YEAR BOND YIELD	2.39%	2.80%	-	3.00%	-
WTI OIL (US$/bbl)	$59.01	$58.00	-1.71%	$58.00	-1.71%
C$ (vs USD)	0.75	0.75	0.35%	0.74	-0.99%
Recent values as of: March 28, 2019					
Source: Factset					

Exhibit 2: Recommended Asset Allocation

	Asset Mix Breakdown							
	GROWTH (Canadian Core Model)				INCOME & GROWTH (North American Yield Model)			
	Recommendation	Benchmark	Diff +/-		Recommendation	Benchmark	Diff +/-	
CANADA								
TSX	59.70%	55.00%	4.70%		31.60%	30.00%	1.60%	
GoC BONDS	28.60%	27.64%	0.96%		32.16%	34.55%	-2.39%	
CDN CORP BONDS	6.00%	12.36%	-6.36%		12.09%	15.45%	-3.36%	
T-BILLS/CASH	5.70%	5.00%	0.70%		6.50%	5.00%	1.50%	
UNITED STATES								
S&P 500					17.65%	15.00%	2.65%	
TOTAL	100%	100%	0.0%		100%	100%	0.0%	
ASSET ALLOCATION	Recommendation	Benchmark	Diff +/-	Allowable Range	Recommendation	Benchmark	Diff +/-	Allowable Range
EQUITIES	59.70%	55.00%	4.70%	20% - 70%	49.25%	45.00%	4.25%	30% - 60%
BONDS	34.60%	40.00%	-5.40%	20% - 70%	44.25%	50.00%	-5.75%	30% - 60%
CASH	5.70%	5.00%	0.70%	0% - 50%	6.50%	5.00%	1.50%	0% - 40%
TOTAL	100%	100%	0%		100%	100%	0%	
GEOGRAPHIC EQUITY ALLOCATION	Recommendation	Benchmark			Recommendation	Benchmark	Diff +/-	
CANADA	100.00%	100.00%			64.16%	66.67%	-2.51%	
UNITED STATES	0.00%	0.00%			35.84%	33.33%	2.51%	
TOTAL	100%	100%			100%	100%	0%	
Recent values as of: March 28, 2019								
Source:Factset								

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