

Asset Allocation Strategy

CIO Office | March 2024

Through the mist

Highlights

- After a brief hesitation, equities rallied again in February, with markets seemingly operating under a scenario of resilient economic growth. Yet, recent data are far more confusing than convincing.
- For instance, despite being equivalent in theory, GDP and GDI readings of economic growth diverge like never before. Meanwhile, on a forward-looking basis, OECD leading indicators suggest a pick-up in growth is underway, while the Conference Board's calculation of its counterpart indicates the opposite. And, as if that weren't enough, U.S. inflation interrupted its series of downward surprises, just as Canadian inflation was headed the other way.
- If inflation should continue to slow (beyond some occasional bumps), there are definitely signs of stabilization in economic activity popping up on our radar. Combined with the Fed that goes so far as to say that economic data *"doesn't need to be better than what we've seen"* to cut rates in 2024, this increases the chances that equity optimism will persist in the short term. Does that mean we're on track to repeat the soft landing of the mid-90s?
- Not so fast. Back then, monetary policy had never really crossed the restrictive threshold. Today, rates are the most restrictive since 1981. In 1995, no more than 12 U.S. states had experienced an economic contraction over a 3-month period. Today, it's double that. And, while the equity risk premium is comparable to the 1994-1997 period, our global equity-bond valuation indicator is already at levels that were seen near the peak of the tech bubble.
- Overall, economic fog calls for modest deviations, which is why we increased our equity allocation on February 1. However, it still seems premature to unreservedly anticipate a soft landing – and, therefore, to opt for a pro-risk strategy.

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.

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Market Review

Fixed Income

- February was the second consecutive month of losses for the Canadian bond universe, bringing the asset class' performance to -1.7% since the start of 2024. To be fair, markets had started the year with fairly ambitious rate-cut expectations. These expectations were gradually revised to later this year, pushing bond yields higher.
- In the U.S., corporate bonds underperformed riskier High Yield securities, the latter being less sensitive to changes in interest rates.

Equities

- Global equities posted a fourth consecutive month of gains, supported once again by the outperformance of the S&P 500. Emerging Markets, meanwhile, finished in second place thanks to a trend reversal in China. The S&P/TSX and the MSCI EAFE underperformed.
- Within U.S. equities, both technology sectors and more cyclical sectors such as Industrials and Materials performed well on a monthly basis.

FX & Commodities

- Oil prices rose sharply for the second month running, taking their year-to-date gain to 10.2%. On the other hand, gold prices were close to flat on the month.
- The USD continued to appreciate in February as U.S. growth once again outperformed that of other developed countries.

Table 2 Market Total Returns

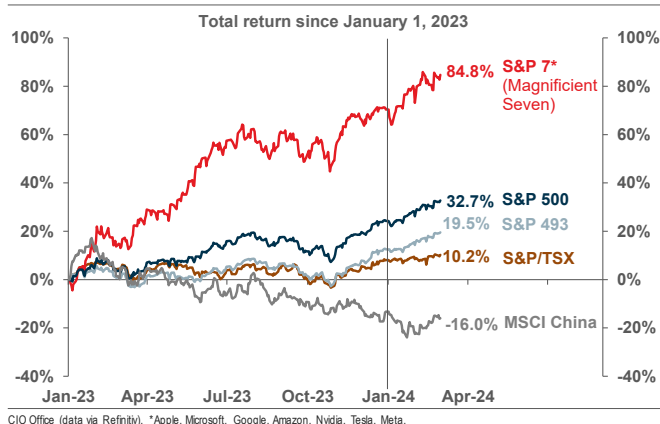
Asset Classes	Feb	YTD	12M
Cash (S&P Canada T-bill)	0.4%	0.8%	4.9%
Bonds (ICE BofA Canada Universe)	-0.4%	-1.7%	3.6%
Short Term	0.0%	-0.1%	4.3%
Mid Term	-0.6%	-1.8%	3.4%
Long Term	-0.8%	-4.1%	2.7%
Federal Government	-0.5%	-1.6%	2.7%
Corporate	0.3%	-0.4%	6.4%
S&P/TSX Preferred Shares	0.1%	5.9%	5.6%
U.S. Corporate (ICE BofA US\$)	-1.4%	-1.2%	6.1%
U.S. High Yield (ICE BofA US\$)	0.3%	0.3%	11.0%
Canadian Equities (S&P/TSX)	1.8%	2.4%	9.2%
Communication Services	-4.7%	-2.0%	-8.1%
Consumer Discretionary	2.2%	3.5%	10.2%
Consumer Staples	5.2%	7.2%	16.3%
Energy	3.7%	5.4%	12.2%
Financials	2.3%	2.0%	7.5%
Health Care	8.5%	4.3%	8.5%
Industrials	5.7%	7.9%	15.6%
Information Technology	-1.5%	5.1%	56.2%
Materials	-2.1%	-8.3%	-10.5%
Real Estate	-1.0%	-0.6%	-4.3%
Utilities	-2.3%	-3.6%	-4.6%
S&P/TSX Small Caps	0.8%	0.4%	0.3%
U.S. Equities (S&P 500 US\$)	5.3%	7.1%	30.5%
Communication Services	5.7%	11.0%	58.4%
Consumer Discretionary	8.7%	4.9%	32.6%
Consumer Staples	2.3%	3.9%	8.0%
Energy	3.2%	2.8%	6.2%
Financials	4.2%	7.3%	15.3%
Health Care	3.2%	6.3%	15.9%
Industrials	7.2%	6.3%	22.1%
Information Technology	6.3%	10.5%	58.8%
Materials	6.5%	2.3%	9.2%
Real Estate	2.6%	-2.3%	6.2%
Utilities	1.1%	-1.9%	-1.2%
Russell 2000 (US\$)	5.7%	1.5%	10.0%
World Equities (MSCI ACWI US\$)	4.3%	5.0%	23.8%
MSCI EAFE (US\$)	1.8%	2.4%	15.0%
MSCI Emerging Markets (US\$)	4.8%	-0.1%	9.2%
Commodities (GSCI US\$)	0.9%	5.4%	5.0%
WTI Oil (US\$/barrel)	3.9%	10.2%	2.9%
Gold (US\$/oz)	-0.1%	-1.0%	12.0%
Copper (US\$/tonne)	-1.2%	-0.7%	-6.1%
Forex (US\$ Index DXY)	0.9%	2.8%	-0.7%
USD per EUR	-0.4%	-2.0%	2.0%
CAD per USD	1.1%	2.5%	-0.5%

CIO Office (data via Refinitiv, as of 2024-02-29)

Through the mist...

After a brief hesitation, equity markets rallied again in February, thanks in particular to the strong financial performance of U.S. technology giants – especially NVIDIA¹ – but also to a long-awaited rebound in China² (**Chart 1**).

1 | Stocks pursue their ascent...



In doing so, the S&P 500 kept setting new all-time highs, the Index having remained above its 50-day moving average for four months now (**Chart 2**).

2 | ... with the S&P 500 rising decisively...



On the fixed-income side, while trends are less assertive (U.S. 10-year yields are stuck between their key moving averages, **Chart 3**, next page), the rise in bond yields since their December lows has

3 | ... and bond yields remaining hesitant

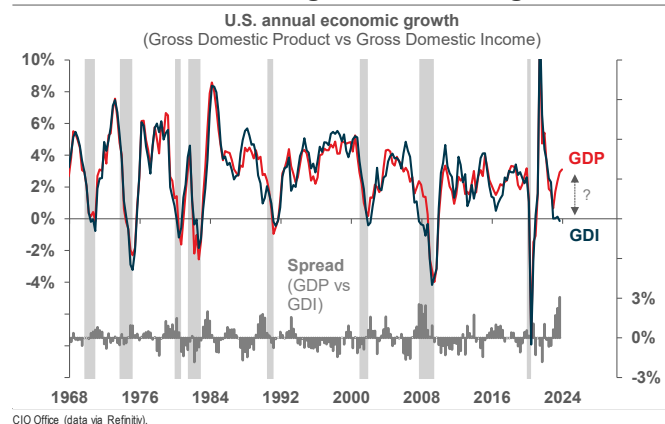


resulted in a disappointing start to the year for bonds.

Clearly, markets are operating under a scenario of resilient economic growth. In reality, however, recent data are far more confusing than convincing.

For instance, while gross domestic product (GDP) and gross domestic income (GDI) should in theory be equivalent (every dollar spent by one person is another person's income), their readings of economic growth over the past year diverge like never before (**Chart 4**)³.

4 | Realized economic growth: who's right?



What's more, on a forward-looking basis, the OECD's Index of U.S. Leading Economic Indicators

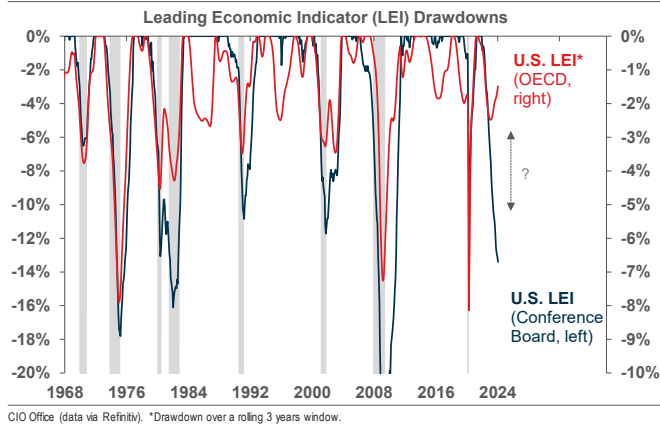
¹ Nvidia posts revenue up 265% on booming AI business, CNBC, February 22, 2024.

² China stocks clock best week in over a year on Beijing's rescue efforts, Reuters, February 8, 2024.

³ Generally speaking, GDP is preferred as it is available earlier, while GDI is considered more reliable as it is less subject to revision. For more details on the differences between these two measures, see this [short article](#) from the St. Louis Federal Reserve.

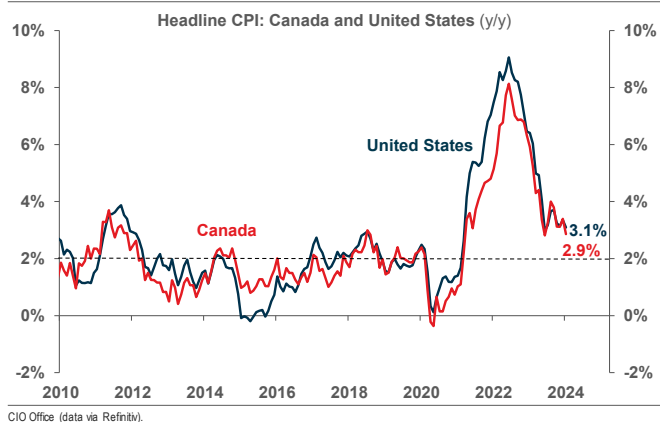
suggests that an acceleration in growth is underway, while its counterpart calculated by the Conference Board says the opposite (**Chart 5**).

5 | Expected economic growth: who's right?



As for inflation, after surprising on the downside for several months in a row, the latest U.S. CPI figures turned out higher than expected, with the annual change dropping only from 3.4% to 3.1% (vs. the 2.9% expected). And, as if that weren't confusing enough, literally the opposite happened in Canada, with annual inflation declining from 3.4% to 2.9% (vs. the 3.1% expected) (**Chart 6**).

6 | Inflation is slowing "more or less" quickly



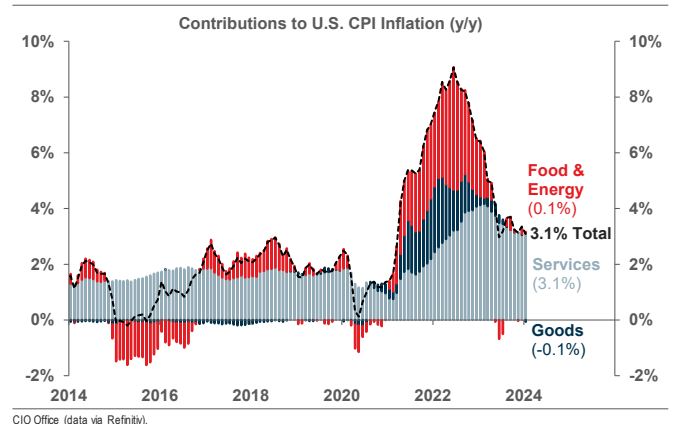
As one can see, the economic fog remains dense. Let's try to shed some light on the situation.

... a rebound in inflation...

Bringing inflation back on target is inevitably a bumpy process, which is partly why we mentioned the risk of short-term upside surprises in our previous monthly report. Nevertheless, we still believe that the slowdown should continue beyond the occasional blips.

The final hurdle to overcome before inflation settles near 2% is the price of services, which now accounts for all U.S. CPI increases over the past year (**Chart 7**).

7 | Services are the last hurdle to overcome...



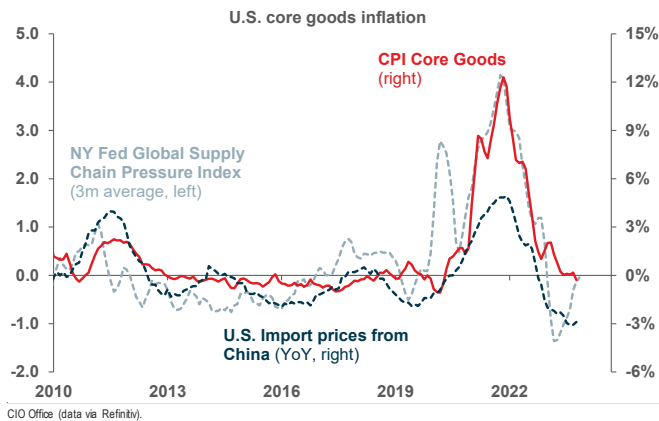
That's not to say we can take everything else for granted. But, unless there's a supply shock within the commodities space, it would be surprising to see food and energy prices jump steadily. Similarly, the preservation of a certain balance in supply chains (despite the challenges facing maritime transport in the Red Sea) and, above all, the deflation exported by China (in a situation of overproduction)⁴ together should help keep the inflation of goods in check (**Chart 8**, next page).

Now, within services, while the recent rebound in house prices could ultimately limit the extent of the slowdown in shelter prices in the CPI, there is still reason to expect a gradual decline in this fundamental component in the U.S.⁵ in 2024, given its lagged reaction function (**Chart 9**, next page).

⁴ China to export deflation to the world as economy stumbles, Financial Times, February 8, 2024.

⁵ The housing inflation situation differs in Canada. See [this article from NBF Economics and Strategy](#) for the latest details on Canadian inflation.

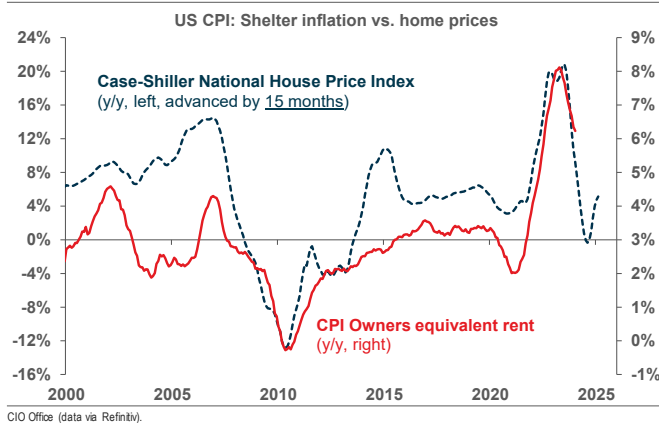
8 | ... with goods prices likely to remain contained



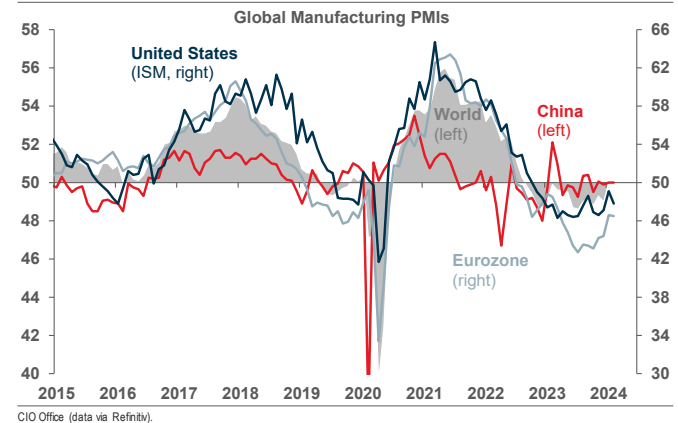
10 | ... and so is wage growth



9 | Shelter inflation should continue to slow down...



11 | Manufacturing activity is stabilizing...



Finally, at a higher level, wage growth is a key determinant of service prices and here also the trend seems to be toward a gradual slowdown, as indicated by our model incorporating several surveys on labour demand (**Chart 10**).

... and growth?

There are definitely signs of stabilization – or even recovery – in economic activity popping up on our radar in addition to those we mentioned last month.

Specifically, despite recent headlines of recessions in Japan⁶ and in Europe^{7,8}, the trough in global

manufacturing activity indicators (PMIs) appears to be behind us, at least in the short term (**Chart 11**).

In the U.S., the February PMI update even saw the volatile but leading "new orders" component rise above 50 (the threshold dividing growth from contraction) for the first time since September 2022 (although back slightly below 50 on March 1st, **Chart 12**, next page).

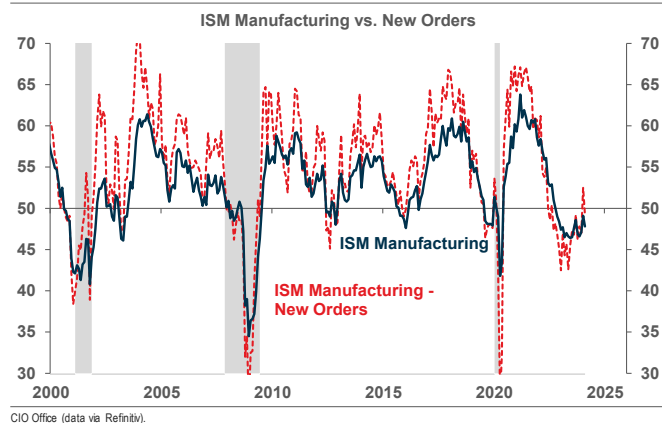
Nevertheless, while the manufacturing sector seems to be recovering, the sustainability of any cyclical rebound ultimately depends on consumers' ability to continue buying goods produced and

⁶ Japan is no longer the world's third-largest economy as it slips into recession, CNBC, February 14, 2024.

⁷ UK economy slipped into technical recession at the end of 2023, CNBC, February 15, 2024.

⁸ Germany's economy is on shaky ground and glimmers of hope are few and far between, CNBC, February 12, 2024.

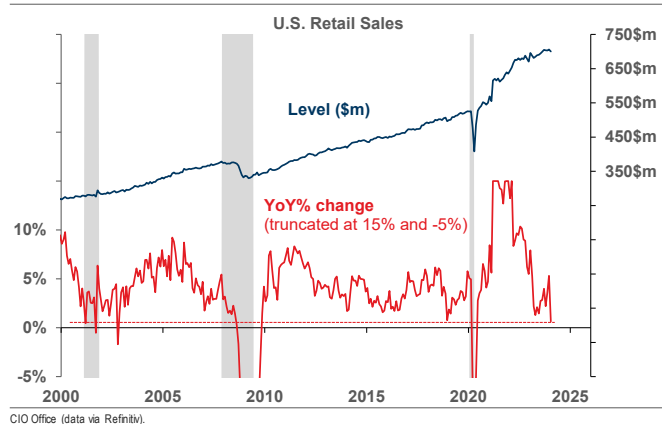
12 | ... with new orders on the rise ...



services offered, as they did in 2023. In this respect, nothing is certain.

Indeed, recent retail sales figures showed annual growth of just 0.6%, a markedly lower-than-expected increase which has rarely been seen outside of recessions since 2000 (**Chart 13**).

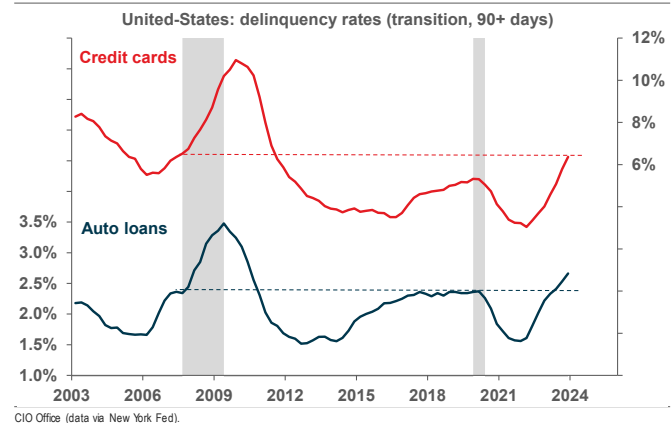
13 | ... but consumers seem to be losing steam...



In addition, new data on credit cards and car loan delinquency rates reveal that difficulties in making payments are at their highest in more than a decade, and similar or superior to those seen at the start of 2008 (**Chart 14**).

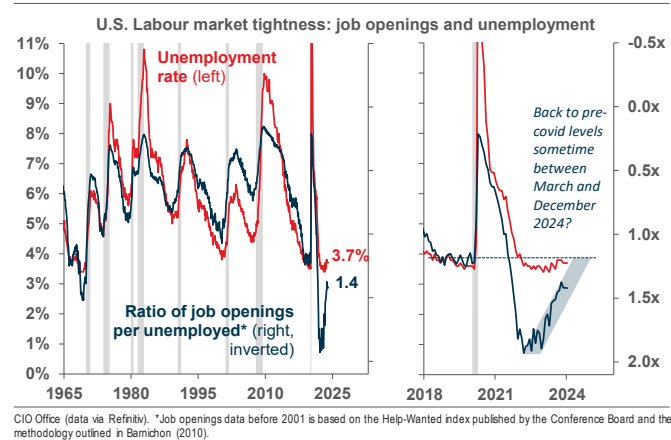
Even so, it remains difficult to conceive of major cuts in consumer spending provided that those looking for work have little trouble finding it. For now, this is still the case, with around 1.4 job openings for every unemployed person. However, if the trend continues – which is generally the case in

14 | ... as delinquency rates trend higher



the labour market – job openings should continue to drop, reaching pre-pandemic levels by the end of 2024 (**Chart 15**).

15 | The labour market holds the key



The hope is that the slowdown in the job market will stop there, close to the equilibrium that prevailed at the end of 2019 owing, among other things, to perfectly timed rate cuts. And in this regard, the thesis suggesting that the Fed is in the process of orchestrating a repeat of the soft landing witnessed in the mid-1990s seems to be growing in popularity.

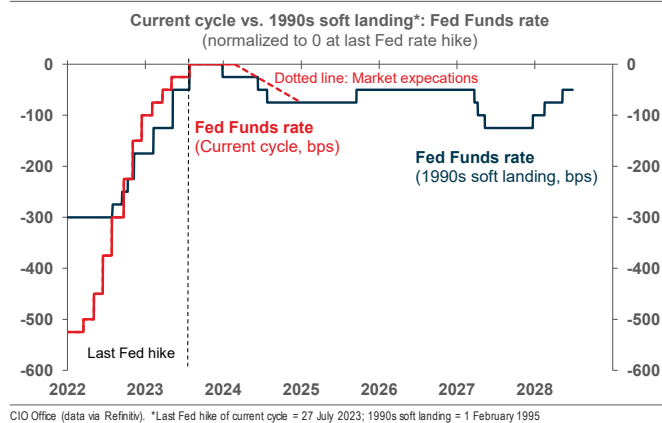
Landing like it's 1995?

Whether it's the final outcome or not, the signs of stabilization in the manufacturing sector combined with the Fed saying that economic data "doesn't need to be better than what we've seen, or even as

*good. It just needs to be good*⁹ in order to cut rates in 2024 increases the chances that stock markets will continue to operate under a scenario similar to that of the mid-1990s in the short term.

Recall that after 300 basis points of rate hikes, Alan Greenspan cut his benchmark rate "only" three times in 1995 – much like the Fed and markets are projecting for 2024 (**Chart 16**) – all without experiencing a recession.

16 | Is the mid-90s a suitable blueprint?



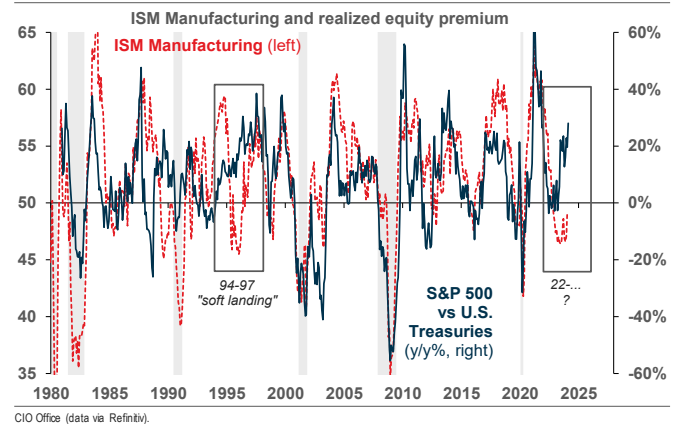
We can certainly draw a parallel between the excitement generated by the emergence of the Internet in those days and the promise of generative artificial intelligence today. Indeed, such an environment had enabled U.S. equities to (exceptionally) shrug off cyclical fluctuations and pursue their ascent back then, as was the case in 2023 (**Chart 17**).

However, despite the apparent similarities with 1994-1997, it still seems premature to unreservedly anticipate a soft landing for three key reasons.

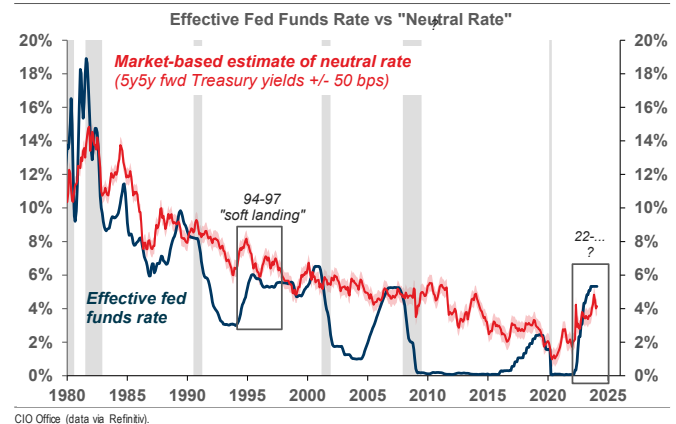
First, on the monetary front, the 300 bps of rate hikes in 1994 had never really pushed Fed policy into restrictive territory. Today, the 525 bps of rate hikes since 2022 make Jerome Powell's policy the most restrictive since 1981. Recall that the U.S. economy has never escaped a recession following a restrictive monetary policy, even when assessed on the basis of a market-derived estimate of the

neutral rate (and, therefore, never revised ex-post, **Chart 18**).

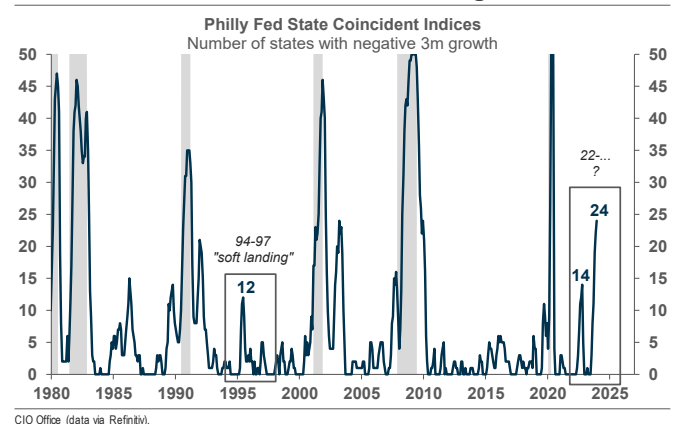
17 | There are definitely similarities...



18 | ... but the monetary backdrop is quite different...



19 | ... as is the breadth of economic growth



⁹ Quote from Jerome Powell's 60 Minutes interview, February 4, 2024.

Second, the economic slowdown process may already have passed the point of no return. In 1995, no more than 12 states experienced an economic contraction over a 3-month period. If the U.S. economy has indeed avoided the worst in 2022 with a maximum of 14 states in contraction reached in October of that year (the month of the S&P 500's last low), we currently face a situation where almost half of the states are showing negative growth in their coincident indicator over 3 months. Once again, this has never happened outside of a recession (**Chart 19**, previous page).

Finally, in terms of valuations, the situation is more nuanced. On the one hand, although the price-earnings (P/E) ratio is already higher than at any time during the 1994-1997 period, the risk premium is close to the 1994-1997 average. What's more, the tech bubble demonstrated that investor euphoria can drive valuations to far more exuberant levels, with the P/E ratio rising to 25x and the risk premium dropping to zero by the turn of the millennium (**Chart 20**).

Nevertheless, on a tactical horizon, we primarily rely on our global equity-vs-bond valuation indicator, which is far more effective at signalling the risk of a trend reversal. In this respect, we are already at levels that were seen near the peak of the tech bubble in February 2000 (**Chart 21**). Safe to say that expectations are high.

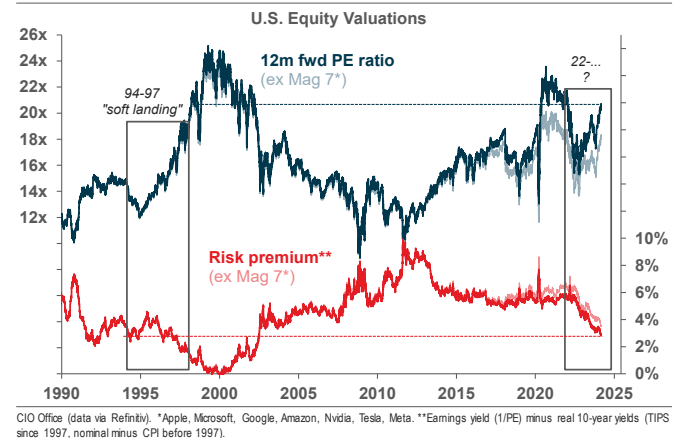
Bottom Line

Overall, economic fog calls for modest deviations, which is why we reduced bonds in favour of equities on February 1.

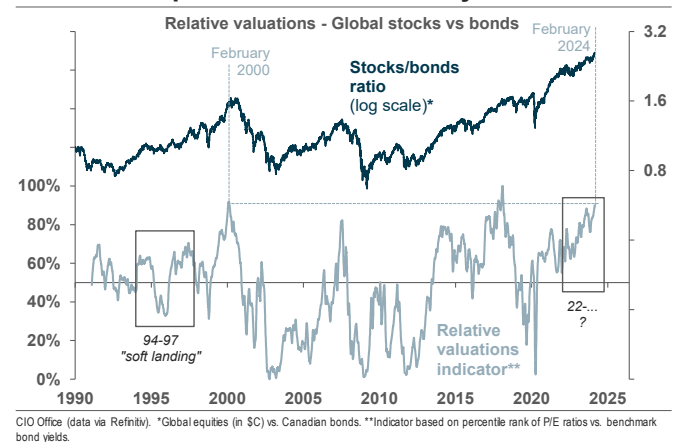
However, the soft landing thesis seems much more fragile than stock markets appear to expect. And after four months above its 50-day moving average, it probably wouldn't take much for the prevailing optimism to be revised downward, as is often the case in such situations (**Chart 22**).

As a result, we are maintaining our defensive bias until (1) market expectations moderate or (2) the

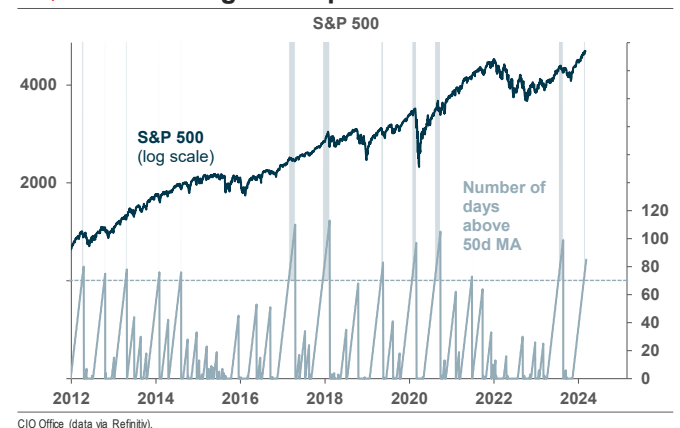
20 | Higher multiples, comparable risk premiums...



21 | ... but expectations are definitely elevated



22 | The bar is high for equities



economic, monetary, and valuation warning signals mentioned above dissipate, confirming that a sustained cyclical recovery is indeed taking shape.

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%	-	-	With global growth expected to trend below potential and non-trivial recession risks, the outlook for equities is precarious in the short term. Meanwhile, bond yields offer attractive risk/reward properties in the face of slowing inflation and central banks moving toward a pivot. Alternatives allow for better control of the total risk of the portfolio through their diversification effects.
Fixed Income	40%	-	41.0%	1.0%	-	-	
Equities	60%	-	56.0%	-4.0%	-	-	
Alternatives	0%	-	3.0%	3.0%	-	-	
Fixed Income							
Government	29%	74%	30.6%	1.1%	75%	0.9%	With rate hikes behind, Treasury yields are likely to decline in the face of a more pronounced economic slowdown. This context calls for a balanced allocation between corporate credit and government securities as well as a slightly longer duration.
Investment Grade	11%	26%	10.4%	-0.1%	25%	-0.9%	
High Yield	0%	0%	0.0%	0.0%	0%	0.0%	
Duration	7.2 yrs	-	8.2 yrs	1.0 yrs	-	-	
Equities							
Canada	21%	35%	18.0%	-3.0%	32%	-2.9%	Macro conditions are undermining the outlook for emerging markets and Canada (more cyclical), compared with the U.S. and EAFE (more defensive). In Canada, the low-volatility factor reduces the cyclical exposure of the S&P/TSX. In the U.S., high-quality, dividend-paying companies are less at risk in a recessionary environment, as are Japanese equities (in yen).
United States	21%	35%	22.0%	1.0%	39%	4.3%	
EAFE	12%	20%	13.0%	1.0%	23%	3.2%	
Emerging markets	6%	10%	3.0%	-3.0%	5%	-4.6%	
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%	-	58.7%	-2.3%	-	-	The overall portfolio strategy entails an overexposure to the U.S. dollar and yen, mainly relative to emerging market currencies. This positioning reflects the geographic breakdown within equities as well as a desire to favour currencies with refugee-value properties in a more challenging economic backdrop.
U.S. Dollar	21%	-	25.3%	4.3%	-	-	
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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