

Asset Allocation Strategy

CIO Office | October 2021

Autumn headwinds

Highlights

- Global equities managed to close a 6th consecutive quarter of gains (in C\$), although the pace of stocks' return slowed as headwinds picked up late in the period. In many respects, September was the opposite of the Summer months, as a rise in interest rates weighed on markets and high growth stocks.
- The topic of inflationary pressures should continue to be of concern to markets as both temporary and structural factors are simultaneously at play. Beyond the path inflation ultimately takes, the key for investors will be what central banks do in parallel.
- The Fed's latest announcements confirm that the Central Bank is initiating a transition from its ultra-accommodative monetary policy and suggest this shift may be taking place even faster than initially anticipated. The Institution should continue to exercise great caution, but the environment could become increasingly difficult to navigate should the divergence between inflationary and economic surprises continue.
- In Washington, nothing is ever easy, but it is now clear that the tax increases will fall short of the White House's ambitions, if they come to pass. China's policymakers have also remained in the spotlight following the Evergrande debacle, and economic stimulus measures are still pending.
- In sum, our baseline scenario continues to call for a gradual deceleration in growth over the coming months, albeit still positive. Against this background, equity markets should continue to outperform more defensive bonds, while interest rates are likely to pursue their rebound. However, we must expect higher volatility and more modest returns.

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 for details on the base-case economic scenario underpinning these views and Table 4 to see how they translate into a model balanced portfolio.

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Market Review

Fixed Income

- September saw the U.S. 10-year benchmark rate climb quickly back to its highest level since June. The move comes as the outlook for policy rate hikes and the beginning of asset purchase tapering by the FOMC have become clearer.
- Not surprisingly, higher duration bonds suffered the most as a result. Meanwhile, High-Yield spreads tightened in September, falling back down to their Springtime average and helping the asset class finish unchanged for the month.

Equities

- American large cap equities retreated in September, the first monthly drop since January 2021.
- The risk-off mood was broad-based with declines across other major exchanges, although generally less pronounced than in the U.S.. The decline in the Canadian stock market was the least severe of the group.
- At the sector level, only Energy stocks advanced, helped in part by rising oil prices.

FX & Commodities

- The U.S. dollar had climbed to its highest level in a year by the end of the quarter, buoyed by the prospect of rising interest rates as well as a moderate increase in inflation expectations.
- Meanwhile, oil prices popped up, with the WTI closing out last month at its highest level in 3 years.

Table 2 Market Total Returns

Asset Classes	Sept.	Q3	YTD
Cash (3-month T-bills)	0.0%	0.1%	0.1%
Bonds (FTSE CA Univ.)	-1.4%	-0.5%	-4.0%
FTSE CA Short term	-0.4%	0.1%	-0.4%
FTSE CA Mid term	-1.4%	0.0%	-3.0%
FTSE CA Long term	-2.7%	-1.6%	-8.9%
FTSE CA Government	-1.5%	-0.6%	-4.5%
FTSE CA Corporate	-1.1%	-0.1%	-2.4%
BoAML Inv. Grade (\$US)	-1.1%	-0.1%	-1.1%
BoAML High-Yield (\$US)	0.0%	0.9%	4.7%
Preferred Shares	0.9%	2.8%	17.4%
CA Equities (S&P/TSX)	-2.2%	0.2%	17.5%
Energy	8.7%	2.8%	40.9%
Industrials	-2.6%	3.9%	11.0%
Financials	-1.1%	1.1%	24.8%
Materials	-5.7%	-5.6%	-6.0%
Utilities	-2.9%	1.0%	6.0%
Cons. Disc	-4.1%	-6.5%	9.9%
Cons. Staples	-4.2%	4.6%	13.5%
Healthcare	-10.3%	-19.4%	-1.7%
IT	-9.4%	-1.3%	20.1%
Comm. Svc.	-3.2%	0.7%	19.0%
REITs	-3.2%	3.3%	25.8%
S&P/TSX Small Cap	-0.1%	-2.5%	16.7%
US Equities (S&P500 USD)	-4.7%	0.6%	15.9%
Energy	9.4%	-1.7%	43.2%
Industrials	-6.1%	-4.2%	11.5%
Financials	-1.8%	2.7%	29.1%
Materials	-7.2%	-3.5%	10.5%
Utilities	-6.2%	1.8%	4.2%
Cons. Disc	-2.6%	0.0%	10.3%
Cons. Staples	-4.1%	-0.3%	4.7%
Healthcare	-5.5%	1.4%	13.5%
IT	-5.8%	1.3%	15.3%
Comm. Svc.	-6.6%	1.6%	21.6%
REITs	-6.2%	0.9%	24.4%
Russell 2000 (USD)	-3.1%	-4.6%	11.6%
World Eq. (MSCI ACWI)	-4.1%	-1.0%	11.5%
MSCI EAFE (USD)	-2.8%	-0.4%	8.8%
MSCI EM (USD)	-3.9%	-8.0%	-1.0%
Commodities (CRB index)	4.9%	7.3%	36.5%
WTI Oil (US\$/barrel)	9.6%	2.1%	55.7%
Gold (US\$/ounce)	-2.5%	-0.3%	-7.2%
Copper (US\$/tonne)	-6.1%	-4.4%	15.4%
Forex (DXY - USD index)	1.7%	1.9%	4.8%
USD per EUR	-1.8%	-2.3%	-5.3%
CAD per USD	0.5%	2.3%	-0.4%

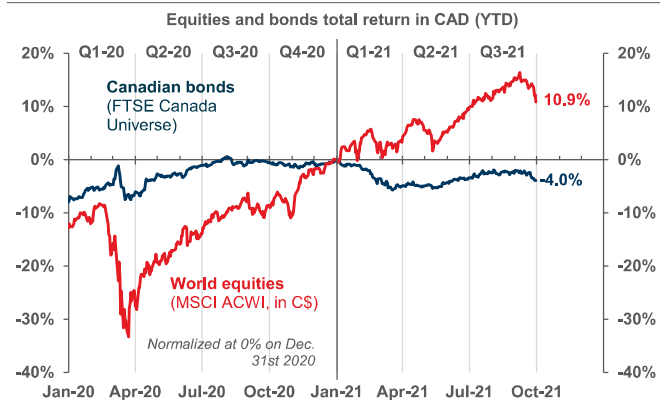
Data via Refinitiv

2021-09-30

Autumn headwinds

Global equities managed to close a 6th consecutive quarter of gains (in C\$)¹ in September, widening their lead over bond markets which remained at a standstill. In spite of this, the pace of stocks' return slowed in Q3-2021 (the weakest performance of the past 6 quarters) after headwinds picked up late in the period (Chart 1).

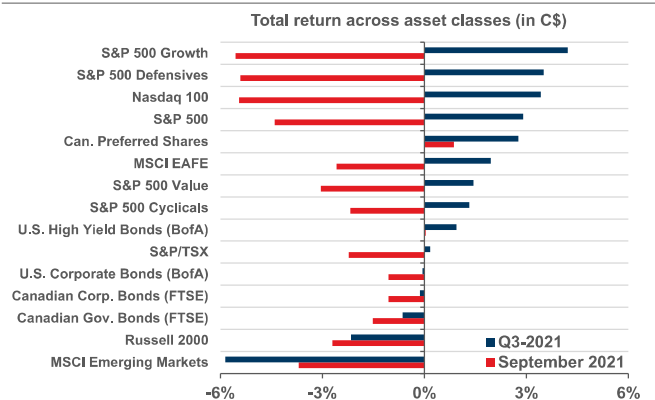
1 | Global equities maintain their large lead...



CIO Office (data via Refinitiv).

Overall, the top of the performance chart for the last quarter belongs to U.S. equities and, more specifically, to the defensive and high-growth segments. However, this is more a reflection of the Summer months, whereas the picture is reversed in September (Chart 2).

2 | ... despite a difficult month of September...

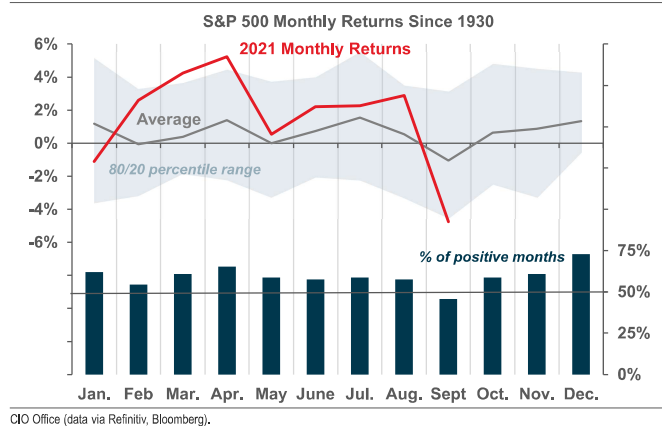


CIO Office (data via Refinitiv).

¹ In Q3-2021, the MSCI ACWI index posted a 1.3% gain in C\$ but a 1.0% loss in US\$.

In fact, September was nothing less than the 1st month of losses for the S&P 500 since January 2021. Interestingly, September has historically been a more challenging month for the stock market; its average return is the lowest, while it is the only month with a positive frequency below 50% (Chart 3).

3 | ... as is often the case



CIO Office (data via Refinitiv, Bloomberg).

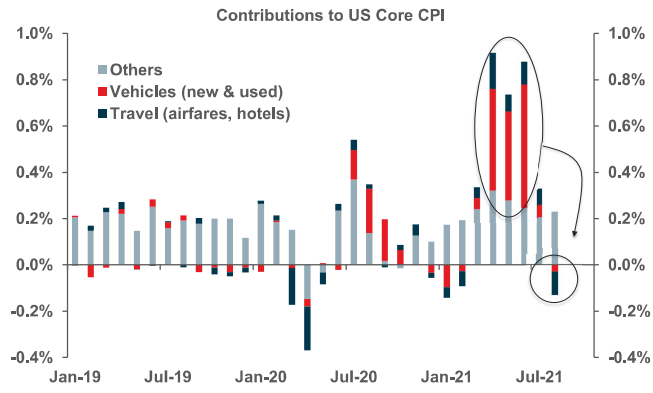
Is this just a speed bump before resuming gains as is usually the case near the end of the year (and especially in December) or will current volatility persist throughout the fourth quarter? To be sure, let's examine the key risk factors that should dictate how markets will behave for the remainder of the year.

Shades of inflation

The topic of the future path of inflation is complex, and certainly not just a matter of "transitory" vs. "persistent" – both temporary and structural factors are simultaneously at play.

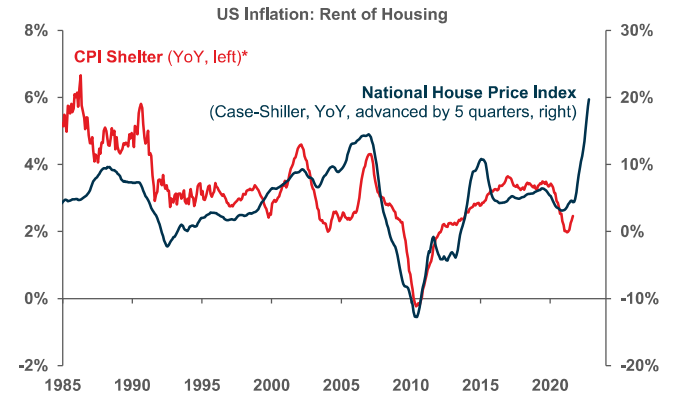
Sure enough, the latest inflation report showed a reversal in prices for the few areas largely responsible for the sharp rise in the core CPI over the Summer months, such as new and used vehicles (Chart 4, next page). This trend supports the argument that the unwinding transitory factors will cause inflation to slow in the coming months.

4 | Some transitory factors are reversing...



CIO Office (data via Refinitiv).

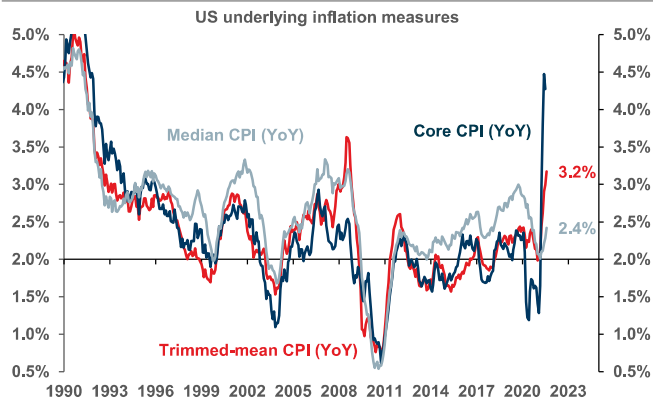
6 | ... should be supported by higher house prices...



CIO Office (data via Refinitiv). *Weighted average of (1) Rent of primary residence and (2) Owners' equivalent rent of residences.

Yet, while we have likely seen the peak in year-over-year inflation, other elements could keep underlying price measures elevated (**Chart 5**).

5 | ... while underlying inflation...



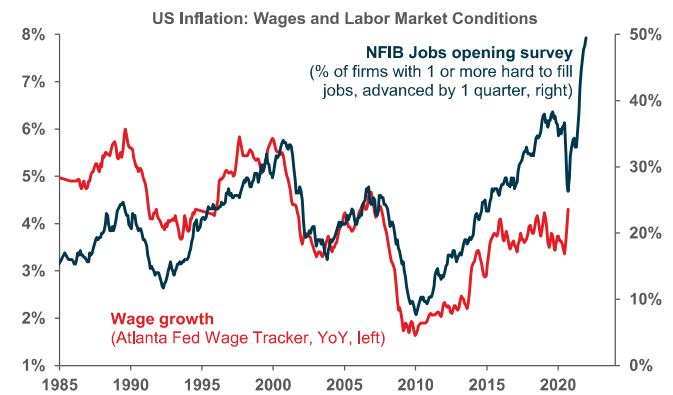
CIO Office (data via Refinitiv).

To start, a category to watch closely will be the cost of rent for residences – firstly, because it represents a little more than 40% of the core Consumer Price Index (CPI) basket and, secondly, because it will likely increase. Historically, a rise in real estate prices has tended to translate (to a certain extent) into a rise in rents with a lag of approximately 5 quarters. Thus, even if the growth in house prices were to slow, their increase over the past year should influence rents for several months to come (**Chart 6**).

A second element to monitor is not explicitly part of the consumption basket, but has a strong influence on overall prices and especially for services: wages. The notion of labour shortages was around before

the pandemic without translating into a sharp increase in wages. That said, the shortage of workers has visibly worsened in 2021, while wages are now showing their strongest increase since 2007 (**Chart 7**).

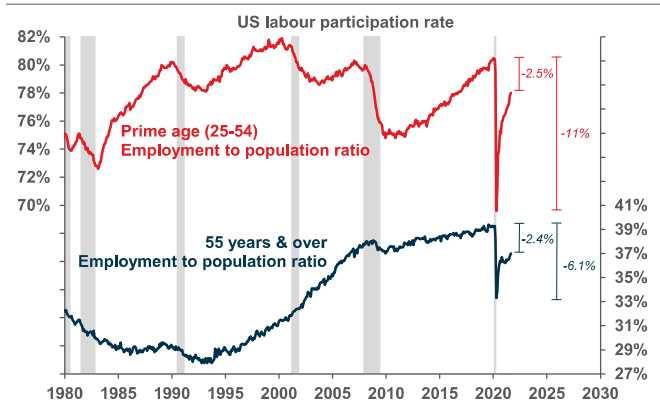
7 | ...and wage growth



CIO Office (data via Refinitiv).

Looking ahead, a rapid recovery in employment would help ease upward pressure on wages, although the labour shortage is set to remain a structural challenge. On this front, it will be important to monitor the evolution of labour participation rates over the coming months, now that the vast majority of supplemental unemployment benefit measures have expired. Nevertheless, it will likely take some time to return to pre-crisis levels, especially for the 55+ population, which includes many workers who have decided to retire earlier due to the pandemic (**Chart 8**, next page).

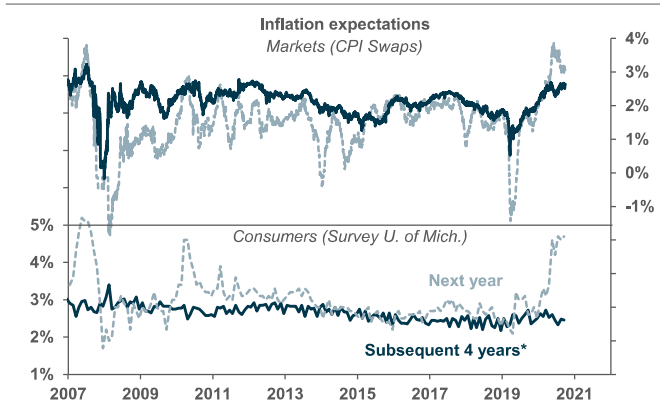
8 | Still a long way to go for employment



CIO Office (data via Refinitiv).

In sum, the most likely scenario in this environment of numerous uncertainties and conflicting forces remains a gradual cooling of inflation toward a level that will nonetheless be higher than in recent years. For their part, consumer surveys still project high inflation in the short term and more moderate rates in the long term (Chart 9).

9 | A gradual cool down is still most likely



CIO Office (data via Refinitiv). *Implicit measure based on 1-year and 5-year expectations.

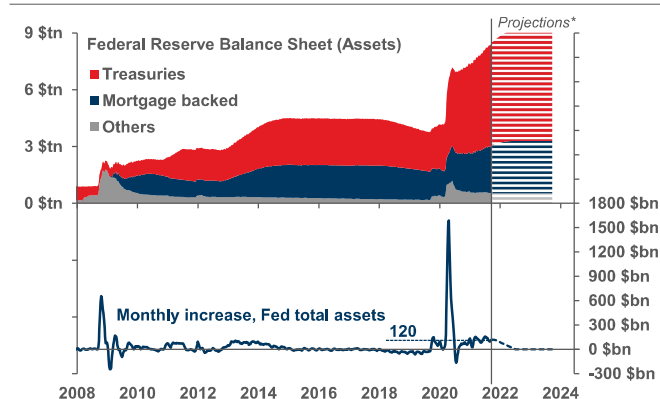
Beyond the path inflation ultimately takes, a key factor for the stock and bond markets will always be what central banks (primarily the Fed) do in parallel. In this regard, the outlook is beginning to become clearer.

Busy policymakers in the U.S....

Speaking at the conclusion of the September 22 FOMC (Federal Open Market Committee) meeting, Jerome Powell essentially confirmed that the

Central Bank was poised to begin a gradual reduction of its asset purchases by stating that "so long as the recovery remains on track, a gradual tapering process that concludes around the middle of next year is likely to be appropriate" and then added that it could begin "as soon as the next meeting." Thus, barring a surprise deterioration in the labour market, the Fed's asset purchase program should taper by about \$15 billion per month starting in November, to see the total balance sheet stabilize near the \$9 trillion mark in June 2022 (Chart 10). Not many surprises here.

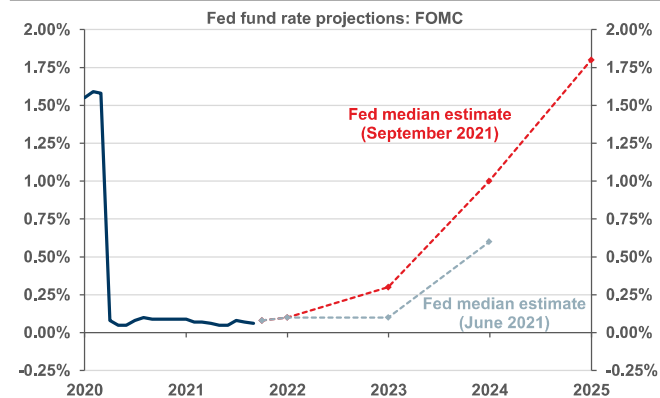
10 | The Fed's asset purchases are set to taper...



CIO Office (data via Refinitiv). *Assumes a 15 billion drop in the pace of purchases each month for 8 months (November 2021 to June 2022)

More revealing, however, was the update of the FOMC members' rate projections. Although dispersion among policymakers remains high, the median projected rate rose by roughly 1 hike in 2022, 1 hike in 2023, and revealed a first projection of 3 hikes in 2024 (Chart 11).

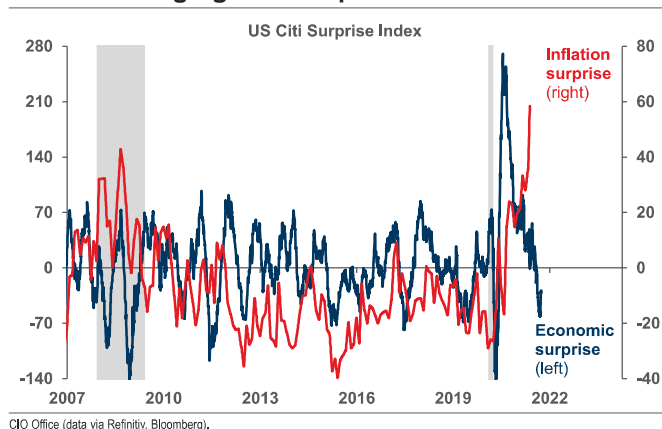
11 | ... while rate hikes projections are moving up



CIO Office (data via Refinitiv, Bloomberg).

These changes confirm that the Fed is initiating a shift away from its ultra-accommodative monetary policy and suggest that it may even be happening somewhat faster than originally expected. To be clear, the Central Bank should continue to exercise great caution as it adapts its stance according to incoming economic data. Still, the environment could become increasingly difficult for policymakers to navigate, should the divergence between inflationary and economic surprises persist (**Chart 12**). While the Fed's new approach is designed to avoid a deflationary spiral, stagflation is no more appealing.

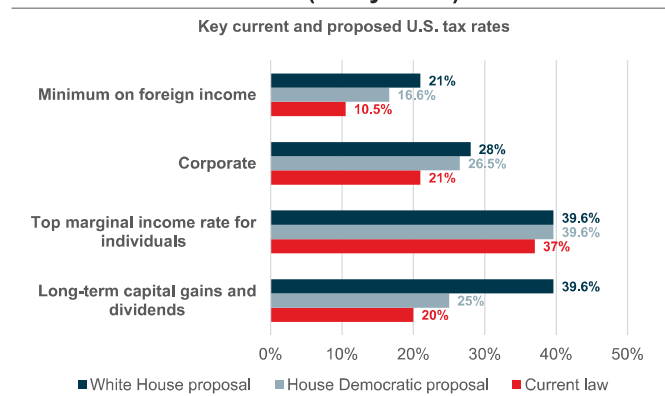
12 | A challenging backdrop for the Fed



In Washington, nothing is ever easy, and the last few days of heated debates on the debt ceiling, infrastructure, and the social plan are perfect examples. Assuming that Congress resolves the recurring debt ceiling dispute by October 18² (which is not the case as of this writing), the main factor for the markets should be the tax rates included in President Biden's \$3.5 trillion social plan. However, disagreements within the Democratic Party itself have made it clear that this figure will be reduced to tax increases that are below the White House's ambitions (**Chart 13**). For the U.S. stock market, these changes would represent a drop of approximately 5% for 2022 earnings.³

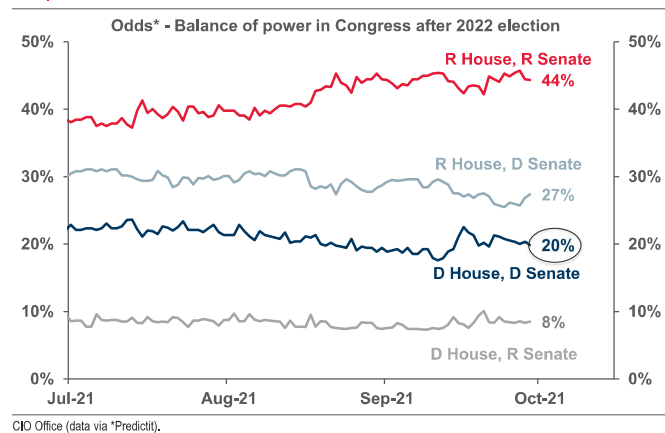
² Janet Yellen warns U.S. risks running out of money by October 18. Financial Times, September 28, 2021.

13 | Tax hikes: less bite (if any at all)



In any case, it seems to be 'now or never' for the Democrats. As time passes, we are getting closer and closer to the November 2022 mid-term elections and, according to the prediction market, the Democrats have only about a 1 in 5 chance of maintaining control of Congress (**Chart 14**).

14 | 'Now or never' for the Democrats



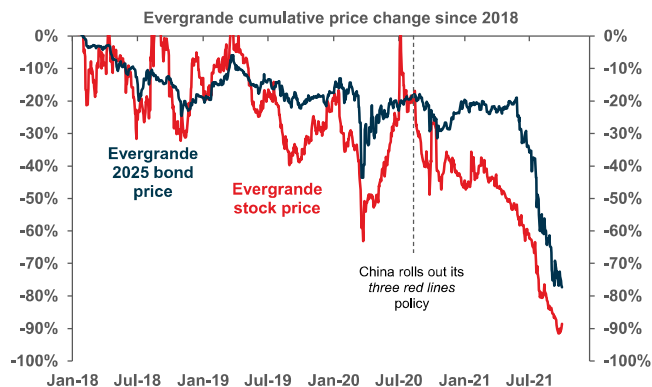
... and in China

Meanwhile in China, policymakers also remained in the spotlight, this time because of the ongoing financial woes of Evergrande, the country's second-largest real estate developer. The company's situation has only worsened since the Chinese government issued a series of new rules (the *three*

³ Source: Goldman Sachs Research.

red lines⁴) aimed at curbing the chronic problem of excess debt in its real estate sector in August 2020. Unable to meet the leverage ratios required by regulators, the company has seen its share and bond prices plummet as it moved or moves? closer to an inevitable default (Chart 15).

15 | Evergrande: intended consequence for Beijing?



CIO Office (data via Refinitiv).

This debacle raised fears of contagion effects across the global economy. However, the situation rather seems to be the intended consequence of the Chinese government's campaign to reduce excessive leverage in the real estate sector, which is viewed as a threat to the long-term sustainability of the country's economy. Consequently, the most likely conclusion is a soft bailout (buyouts of Evergrande's projects and shares bought by other developers and state-owned enterprises) ensuring the survival of this critical sector, but still resulting in losses for the company's shareholders and some of its creditors.

While the impact on global growth is expected to be limited, challenges in the real estate sector are likely to add downward pressure on Chinese growth. Also of concern are rising coal prices and strict carbon emission reduction targets that are causing power shortages and forcing plants to reduce production.⁵ Ultimately, the Chinese government is expected to announce monetary measures aimed at reviving the recently lacklustre growth in credit, which has historically exerted great

⁴ Beijing turns the screws on China's property sector. Financial Times, January 25, 2021.

influence on the country's level of economic activity (Chart 16). But, for now, policymakers seem in no rush. A situation to be followed closely in the coming months.

16 | Downward pressure mounts for Chinese growth

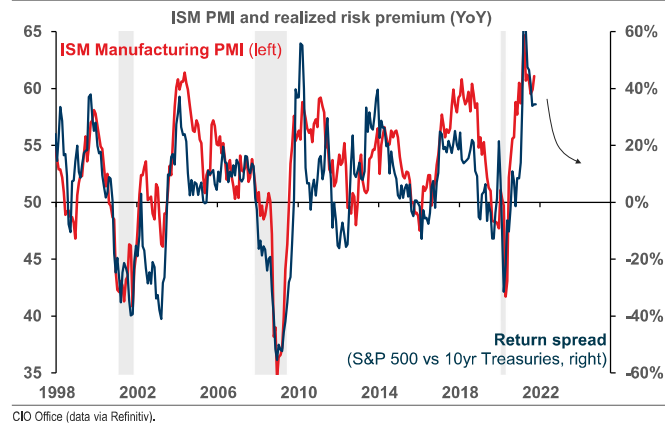


CIO Office (data via Refinitiv). *YoY change in China total social financing in % of GDP.

The bottom line

Our baseline scenario continues to call for a gradual deceleration in growth over the coming months, albeit still positive. Against this background, equity markets should continue to outperform more defensive bonds. However, we must expect higher volatility and more modest returns (Chart 17).

17 | A gradual slowdown is expected



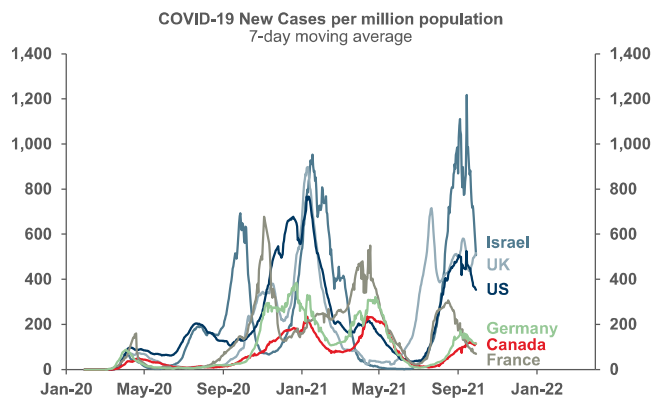
CIO Office (data via Refinitiv).

With this in mind, we reduced our overweight in equities in favour of cash last month, anticipating headwinds from high COVID-19 cases and the

⁵ Power crunch threatens Chinese economic growth, warn banks. Financial Times, September 27, 2021.

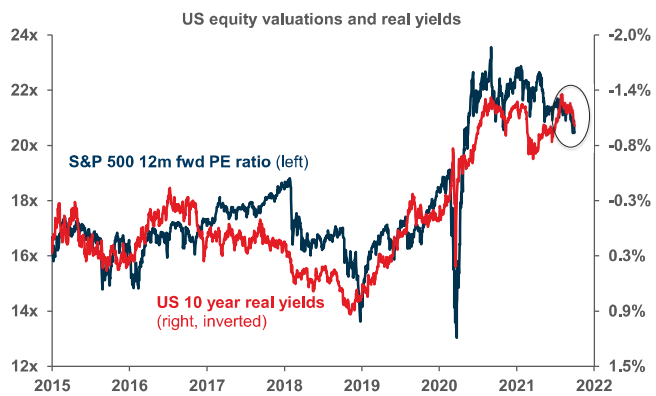
monetary pivot of central banks. Since then, the health situation has taken a more positive turn (**Chart 18**), but the monetary backdrop has indeed led to a rise in Treasury rates that weighed on both bond and equity markets valuations in September (**Chart 19**).

18 | The health situation is stabilizing...



CIO Office (data via Johns Hopkins University).

19 | ... but rapid moves in yields are shaking markets

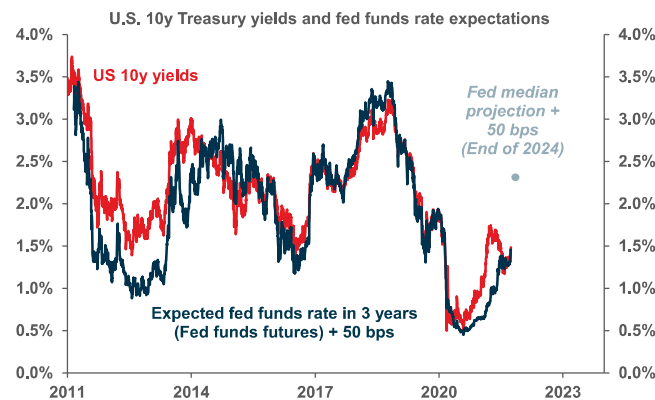


CIO Office (data via Refinitiv, Bloomberg).

A question for many investors is the link between the Federal Reserve's interest rate outlook and 10-year Treasury yields, on which many asset prices depend. This relationship appears to be operating with the Fed's interest rate outlook over a 3-year horizon. These 2 variables have tended to move hand-in-hand since 2011 (when data for the 36-months Fed funds futures contracts began) with a spread of about 50 basis points. According to this analysis, while it was probably premature to see 10-year interest rates near 1.70% at the beginning of the year, it is entirely justified to see them near

1.50% today. What's more, a convergence of market expectations toward the latest FOMC median projection would certainly see bond yields continue to rise (**Chart 20**).

20 | Risks remain to the upside for Treasury yields...



CIO Office (data via Refinitiv, Bloomberg).

This environment should prove favourable to the more cyclical and value-oriented segments of the equity markets over the more defensive growth style, as witnessed in September (**Chart 21**). Geographically, this tends to favour the Canadian market – the most cyclical/value oriented – over the U.S. market – the most growth/defensive oriented – and we remain positioned in this direction (**Chart 22**, next page). In addition, relatively lower valuations in Canada suggest less downside risk should an episode of increased risk aversion occur (**Chart 23** next page).

21 | ... which tends to favor cyclical stocks...



CIO Office (data via Refinitiv). *Cyclical/Value = Financials, Cons Discr, Materials, Energy, Industrials, Real Estate. Growth/Defensive = Technology, Communication, Consumer Staples, Health Care, Utilities.

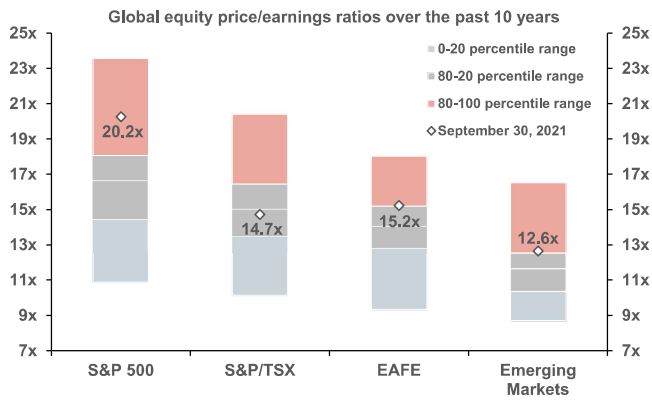
22 | ... most heavily weighted in Canada

Global Equity Sector Allocation (as of September 28, 2021)

	Emerging Markets	S&P/TSX	S&P 500	EAFE
Information Technology	21%	12%	28%	10%
Financials	19%	32%	11%	17%
Consumer Discretionary	15%	4%	12%	13%
Communication	10%	5%	11%	5%
Materials	9%	11%	3%	7%
Consumer Staples	6%	4%	6%	10%
Energy	6%	13%	3%	3%
Health Care	5%	1%	13%	13%
Industrials	5%	11%	8%	16%
Real Estate	2%	3%	3%	3%
Utilities	2%	5%	2%	3%
Cyclical/Value*	55%	74%	40%	59%
Defensive/Growth**	45%	26%	60%	41%

CIO Office (data via iShares, SSGA). *Financials, Cons Discr, Materials, Energy, Industrials, Real Estate, **Technology, Communication, Consumer Staples, Health Care, Utilities.

23 | More limited downside risk for the S&P/TSX



CIO Office (data via Refinitiv).

Table 3 Base Case Scenario

Scenario (prob.)*	Key elements and investment implications
Base case 70%	Waves of new COVID-19 cases arise at different times in different countries. The number of hospitalizations and deaths fluctuates, but remains far from reaching a state of crisis thanks to the success of the vaccination campaigns that are ramping up in developing countries.
	The economic recovery continues, but the pace of growth slows. Strong underlying trends such as a substantial accumulation of excess savings, a strong recovery in the service sector and accommodative monetary conditions maintain growth rates above their long-term average.
	The majority of developed countries policy makers pursue a gradual and cautious phase-out of emergency fiscal support. In the U.S., the Biden administration manages to pass a social package that includes some tax increases, albeit of a smaller magnitude than originally planned.
	Annual inflation declines slightly but remains volatile. Several transitory forces exerting upward pressure on prices abate. Still, a strong economy and structural factors keep inflation relatively high. Central banks initiate a gradual and cautious adjustment of their ultra-accommodative monetary policies.
	→ Bond yields rise gradually while global equities continue to rise along their long-term trend. Leadership remains volatile but edge in favour of cyclical and Canadian equities.
Bullish 15%	A decline in COVID-19 infectiousness combined with an increase in global vaccination rates allows for a definitive victory over the pandemic. As economies reopen, employment recovers rapidly. Consumer sentiment jumps.
	After rising sharply, inflation settles near historical averages as supply adjusts. Chinese monetary authorities announce new measures to stimulate their economy while Western central banks keep policy rates at record lows.
	→ Bond yields rise marginally while the U.S. dollar depreciates. Global equities surge above their long-term trend. Leadership remains volatile. Emerging markets equities outperform significantly.
Bearish 15%	Strong inflationary pressures push long-term inflation expectations into a range that forces central banks to tighten monetary conditions earlier than expected. In parallel, uncertainty over U.S. fiscal policy, monetary and regulatory policies in China, and Sino-U.S. relations force markets to recalibrate their expectations.
	Vaccination campaigns fail to counter the rapid spread of coronavirus variants in some parts of the world. Persistent fears over the disease affect consumer sentiment negatively, global growth slows substantially.
	→ Bond yields volatility increases and the U.S. dollar shoots higher. Equities venture in correction territory. Leadership is highly volatile but edges in favour of growth (value) stocks in the COVID revival (inflationary pressure) scenario.

CIO Office. Last update: October 1, 2021 (updated quarterly unless an event demands a revision). *Subjective probabilities based on current market conditions and subject to change without notice.

Table 4 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%	-	2.0%	2.0%	-	-	With above-trend global growth, the outlook for equities compares favourably to bond markets, which are showing yields close to an all-time low. Alternatives allow for better control of the total risk of the portfolio and offers protection against sustained inflation. A modest cash position provides an extra level of prudence, given relatively weak risk-reward prospects across asset classes. Overall, this positioning is pro-risk.
Fixed Income	40%	-	30.0%	-10.0%	-	-	
Equities	60%	-	63.0%	3.0%	-	-	
Alternatives	0%	-	5.0%	5.0%	-	-	
Fixed Income							
Government	28%	73%	16.8%	-11.2%	54%	-18.8%	Highly accommodative monetary conditions and a sustained recovery in economic activity should lead corporate bonds to outperform government securities. For risk control purposes, we are sticking to investment grade credit. Treasury yields should rise modestly as central banks begin to normalize their policies, but we expect real yields to remain negative.
Investment Grade	12%	27%	14.2%	2.2%	46%	18.8%	
High Yield	0%	0%	0.0%	0.0%	0%	0.0%	
Duration	7.8 yrs	-	7.5 yrs	-0.3 yrs	-	-	
Equities							
Canada	21%	35%	23.0%	2.0%	37%	1.6%	Prevailing uncertainty argues for a diversified approach in equities. Canada should outperform the U.S. under a backdrop of strong global growth and slightly higher rates. In EM, we favour cyclical and value sectors (RAFI Fundamental, 2.3%). In the U.S., we favour the high-quality (MSCI Quality, 4.5% weight) dividend-paying (Div. Aristocrats, 4%) companies and the equal weight index (3%) for their diversified properties.
United States	21%	35%	21.0%	0.0%	33%	-1.6%	
EAFE	12%	20%	12.6%	0.6%	20%	0.0%	
Emerging markets	6%	10%	6.3%	0.3%	10%	0.0%	
Alternatives							
Inflation Protection	0%	0%	2.0%	2.0%	40%	40.0%	The macroeconomic environment remains favourable to gold, with real interest rates likely to remain negative and the U.S. dollar to depreciate. Accordingly, TIPS should outperform their nominal counterparts, in addition to providing more direct inflation protection and little volatility. This asset mix offers low correlation with traditional assets.
Gold	0%	0%	3.0%	3.0%	60%	60.0%	
Non-Traditional FI	0%	0%	0.0%	0.0%	0%	0.0%	
Uncorrelated Strategies	0%	0%	0.0%	0.0%	0%	0.0%	
Foreign Exchange							
Canadian Dollar	61%	-	57.0%	-4.0%	-	-	Our overall portfolio strategy places us overweight in U.S. dollars versus our benchmark, solely through our gold position. Although our base case scenario is consistent with a slight appreciation of the Canadian dollar, we maintain this positioning for risk management purposes as gold in CAD offers more attractive historical properties from a portfolio construction standpoint.
U.S. Dollar	21%	-	24.0%	3.0%	-	-	
Euro	5%	-	4.8%	0.3%	-	-	
Japanese Yen	3%	-	3.2%	0.2%	-	-	
British Pound	2%	-	1.8%	0.1%	-	-	
Others	9%	-	9.2%	0.5%	-	-	

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 color 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).

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General

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