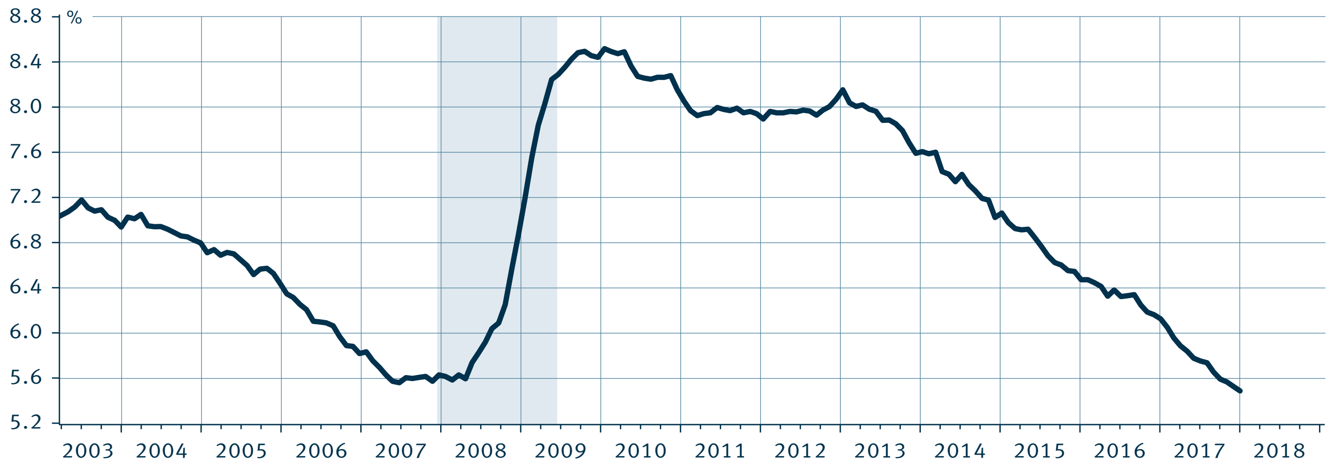
June 2018
Building your financial future

Investment Strategy

World

The world economy continued to expand in Q1, albeit at a slower pace. The latest data from the CPB pointed to a deceleration in world industrial output growth during the first quarter (+3% annualized) due to softer growth in advanced economies. The moderation in the OECD was felt particularly in the eurozone and Japan. Nonetheless, there were some positive stories in Q1. Emerging markets remained strong, seeing the fastest pace of growth for industrial production since 2012. That can be partly attributed to China's resilient economy, which seems to be having positive spillovers through Asia via supply chains. China's real GDP reportedly grew 6.9% on a year-on-year basis during the first quarter and remains well on track to hit the government's annual growth target of 6.5%. But there are still significant uncertainties about the sustainability of growth in international trade flows amidst mounting protectionism. At this juncture, we still see the global economy expanding in excess of 3.5% this year.



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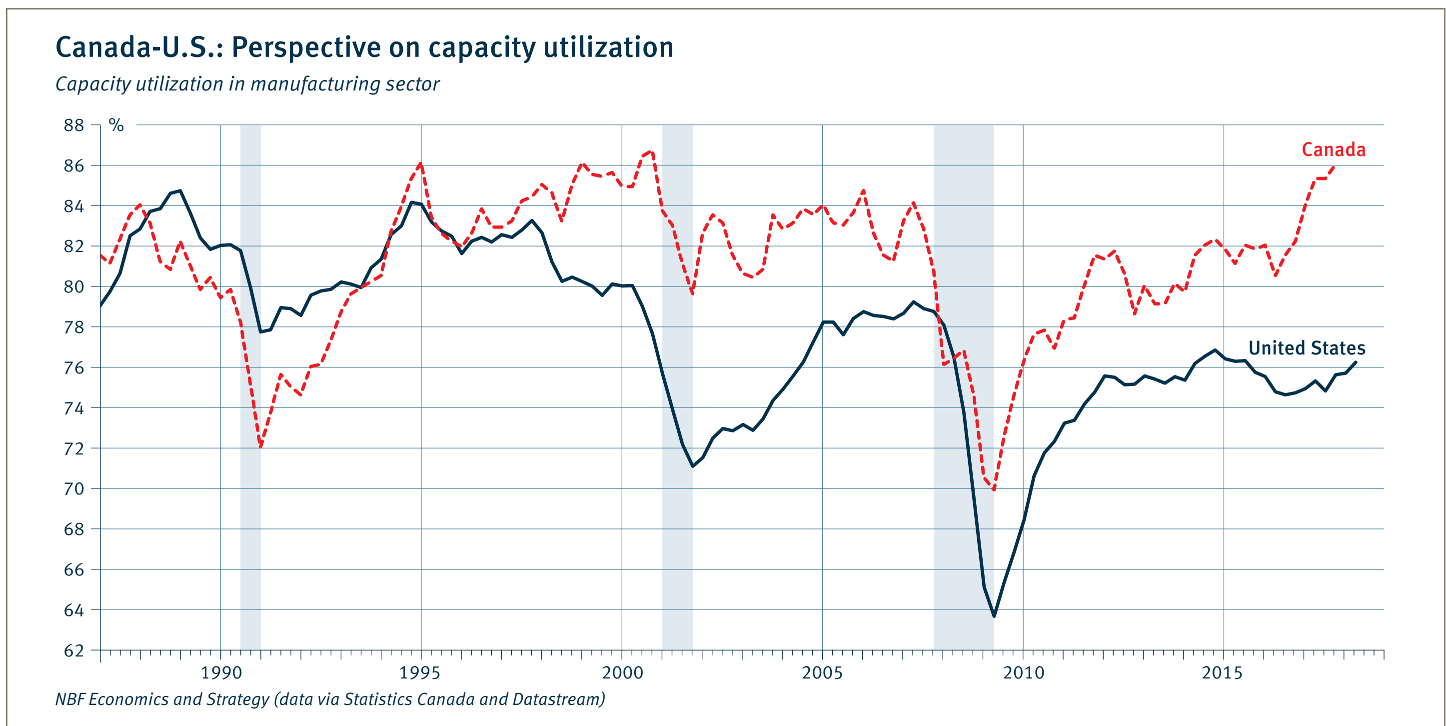
NATIONAL BANK FINANCIAL
WEALTH MANAGEMENT

Canada

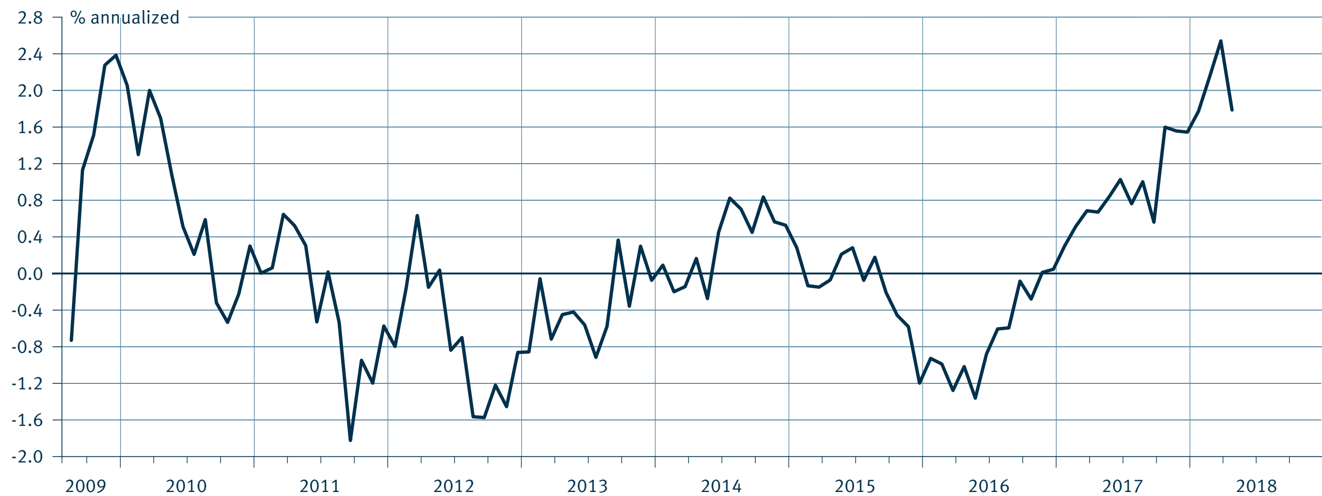
The Canadian economy expanded at an annualized pace of 1.3% in the first quarter of 2018, as domestic demand provided more than an offset to an expected drag from trade, the latter due to surging imports. Recent indicators coupled with higher prices for commodities warrants optimism for stronger growth in the second quarter and record corporate profits. Though ongoing NAFTA negotiations do not inspire confidence, considering the recently imposed import tariffs by Washington on Canadian steel and aluminium, it is important to keep in mind that the activity linked to those exports to the U.S. account for only 0.3% of our GDP.

The Bank of Canada has been hammering away at the message that high household debt makes the Canadian economy more sensitive to rate increases than in the past. Our simulation of the mortgage-payment shock resulting from higher rates in 2018 and 2019 suggests that it is likely to be manageable, creating limited headwinds to the economy (less than 0.2% of GDP in 2018 and 2019). This analysis is based on the assumption that the BoC will normalize gradually and will not push its overnight rate much above 2% this year or next. All told, the Canadian economy remains on track to expand 2.2% in 2018.



United States

A fifth consecutive quarter of above-2% real GDP growth is in the cards for the U.S. economy. Consumption spending seems to be responding in early Q2 to the boost in disposable incomes provided by a healthy labour market and personal income tax cuts. Investment remains strong, coinciding with elevated business confidence. All in all, the data so far does nothing to change our view that U.S. real GDP growth will be near 3% this year, i.e., well above potential. That pace will imply good growth in corporate profits and further monetary policy normalization. Our economic projections lead us to see appropriate fed funds rates of 2.25% in December 2018. As for the longer portion of the yield curve, we think this year's economic environment will be consistent with a 10-year Treasury yield trading above 3.0% in the second half of the year.



Investment Strategy

Global economic activity remained robust last quarter, especially in the U.S., where the unemployment rate fell to its lowest in almost 50 years, and leading indicators point to a continuation of above-trend growth in the months to come. Still, geopolitics took the lion's share of attention in most investors' minds, with the escalation in trade tensions sporadically affecting risk appetite. Market gyrations are to be expected at a later stage of the business cycle, but it must be emphasized that high volatility is not an impediment to positive equity returns, as evidenced by the late 1990s. Aside from the U.S. trade spat, rising anxieties that the extremely strong growth backdrop of recent years may be as good as it gets also have their share of responsibility in the recent market hesitations. While we agree that we might be past peak growth, history shows that the stock market remains the place to be for as long as the economy keeps expanding, although a certain degree of caution is warranted as the business cycle ages. On this basis, we continue to favour equities over their fixed-income alternatives, but have modestly reduced the size of their allocation to lower the risk in our portfolios.

Indeed, the combination of sustained economic growth, accelerating inflation and the central bank's commitment to gradually remove accommodation and hike interest rates should continue to progressively push Canadian and U.S. bond yields upward, a difficult environment for fixed-income assets. Consequently, we advise staying underweight in government bonds or investing in short-duration products. We also favour non-traditional or unconstrained fixed-income solutions.

Inflationary pressures have been particularly strong in Canada as of late, with the latest wage growth figures showing the fastest increase in nine years, and core inflation slightly above the Bank of Canada's midpoint target of 2%. Trade-related uncertainties have compelled the central bank to exercise caution recently, a situation that has prevented the loonie from gaining a significant increase in commodity prices. We acknowledge that the increasing odds NAFTA negotiations will drag into 2019 clouds the outlook for the Canadian dollar, but a complete meltdown in Canada-United States trade relations remains highly unlikely in our view. What's more, monetary policy-makers eventually have no choice but to adjust their tone in the face of growing price pressures, which we expect to translate into smaller yields differential with the U.S. and into a stronger Canadian dollar in the coming months.

One asset that clearly benefited from the surge in raw materials and energy prices is the S&P/TSX, which underwent substantial earnings revisions, allowing it to catch up with other global equity indices after a false start at the beginning of the year. As we expect this typical late-cycle trend to persist, we stick to our allocation titled in Canadian equities' favour. For their part, emerging markets have been impeded by a resurgent U.S. dollar and an escalation of trade tensions between the world's two biggest economies recently. Foreseeing the Trump administration game plan is no easy feat, but a reasonable conclusion is to assume that logic will eventually prevail and that the White House will avoid derailing increasingly interdependent economies. As such, we expect emerging markets to bounce back from their already depressed levels, but the next few months are likely to be marked with many ups and downs.

MODEL PORTFOLIOS	Asset Class	Minimum/ Maximum	Benchmark	Recommended Weighting	Change from Previous Quarter
Income Portfolio					
Investor Profile: You want to preserve your capital or establish a source of periodic income to finance ongoing expenses. You do not find the stock market very attractive because of its volatility, but you are not against the idea of investing a small part of your portfolio in stocks, mainly to counteract the effects of inflation. Your tolerance for risk is low.	Cash equivalents	0% to 20%	5.0%	7.5%	0.0%
	Fixed income (duration: 5.25 years)[1]	60% to 100%	70.0%	66.0%	1.0%
	Canadian equities	0% to 30%	8.0%	9.0%	0.0%
	U.S. equities		8.0%	8.5%	-0.5%
	Foreign equities		4.0%	4.0%	-0.5%
	Alternative investments[2]	0% to 20%	5.0%	5.0%	0.0%
Conservative Portfolio					
Investor Profile: On the whole, you want your portfolio invested in fixed-income securities. Although you can tolerate limited volatility to ensure that your assets will grow, you prefer having a portfolio consisting mainly of fixed-income investments for reasons of stability. Your tolerance for risk is low.	Cash equivalents	0% to 20%	5.0%	6.5%	0.0%
	Fixed income (duration: 5.25 years)[1]	45% to 80%	55.0%	51.0%	1.0%
	Canadian equities	20% to 45%	14.0%	15.5%	0.0%
	U.S. equities		14.0%	15.0%	-0.5%
	Foreign equities		7.0%	7.0%	-0.5%
	Alternative investments[2]	0% to 20%	5.0%	5.0%	0.0%
Balanced Portfolio					
Investor Profile: You give equal importance to achieving growth in your investments and receiving income. You can tolerate moderate changes in market value to ensure growth, but you prefer having a mix of fixed-income investments and equities, for reasons of stability.	Cash equivalents	0% to 20%	5.0%	6.0%	0.0%
	Fixed income (duration: 5.25 years)[1]	30% to 65%	40.0%	35.0%	1.0%
	Canadian equities	30% to 65%	18.0%	20.0%	0.0%
	U.S. equities		18.0%	19.5%	-0.5%
	Foreign equities		9.0%	9.5%	-0.5%
	Alternative investments[2]	0% to 25%	10.0%	10.0%	0.0%
Growth Portfolio					
Investor Profile: Your main goal is capital growth. Although you can tolerate greater volatility in order to increase the value of your assets, you are not prepared to invest your entire portfolio in stocks. Your tolerance for risk is high.	Cash equivalents	0% to 25%	5.0%	6.0%	0.0%
	Fixed income (duration: 5.25 years)[1]	20% to 45%	30.0%	26.0%	1.0%
	Canadian equities	40% to 75%	22.0%	23.5%	0.0%
	U.S. equities		22.0%	23.0%	-0.5%
	Foreign equities		11.0%	11.5%	-0.5%
	Alternative investments[2]	0% to 25%	10.0%	10.0%	0.0%
Maximum Growth Portfolio					
Investor Profile: You want to maximize the eventual return on your capital by investing all or most of your portfolio in the stock market. In doing so, you accept higher volatility of your investment returns in the hope that these returns will ultimately be higher. Your tolerance for risk is high.	Cash equivalents	0% to 30%	5.0%	5.5%	0.0%
	Fixed income (duration: 5.25 years)[1]	0% to 30%	15.0%	11.0%	0.5%
	Canadian equities	55% to 100%	26.0%	27.5%	0.0%
	U.S. equities		26.0%	27.5%	0.0%
	Foreign equities		13.0%	13.5%	-0.5%
	Alternative investments[2]	0% to 30%	15.0%	15.0%	0.0%

1 FTSE TMX Canada Universe Index
2 Includes Hedge funds, global infrastructure and gold

FORECAST	2016	2017	2018 (Forecast)	2019 (Forecast)
Gross Domestic Product %				
Canada	1.4	3.0	2.2	1.9
U.S.	2.7	2.8	2.5	2.1
Inflation %				
Canada	1.4	1.6	2.3	2.1
U.S.	1.3	2.1	2.5	2.3

	June 2018		December 2018		December 2019	
	Canada	U.S.	Canada	U.S.	Canada	U.S.
Rate %						
Short-term rates (T-Bills, 91-Day)	1.43	1.91	1.88	2.08	2.21	2.83
10-year bond yields	2.37	3.03	2.63	3.18	3.09	3.47
30-year bond yields	2.39	3.18	2.65	3.30	3.11	3.55
Canadian dollar	US$ 0.78		US$ 0.83		US$ 0.82	

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