December 2018
Building your financial future

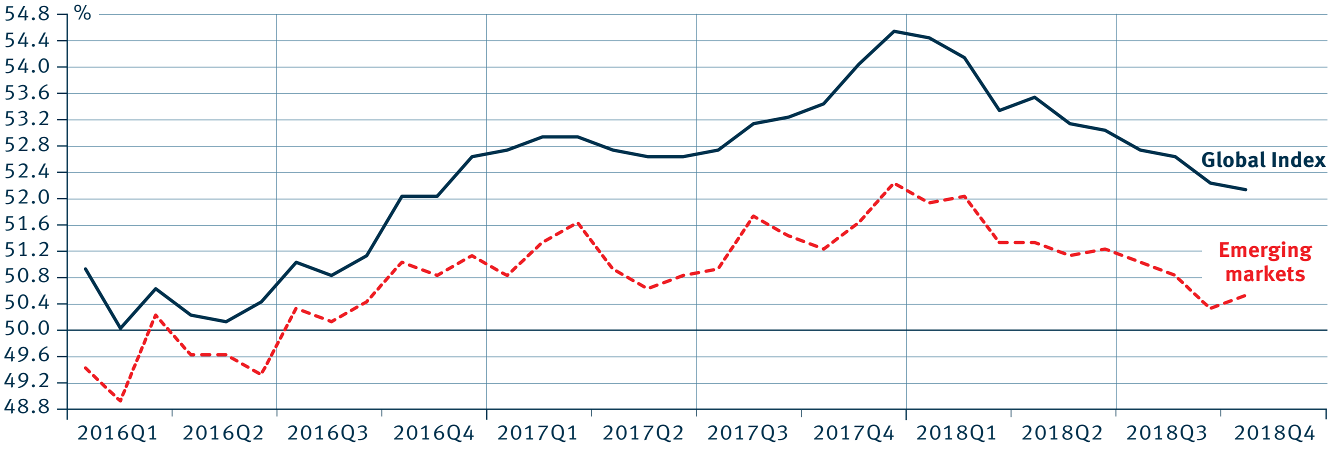
Investment Strategy

World

Declining commodity prices and a string of disappointing purchasing managers indices suggest that momentum is fading for export-centric economies in the final months of 2018. The eurozone, for instance, saw its industrial production decline and Germany even saw its first contraction since 2015 as GDP fell 0.2% annualized in Q3. It's unclear if the eurozone's growth can increase meaningfully in the final quarter of the year or even in 2019. There are indeed major uncertainties hanging over the common currency area brought by Brexit, political tensions from within (read Italy), and trade. While China earned a reprieve at the G20 meeting—the U.S. agreed to delay the imposition of 25% tariffs on roughly half of China's annual exports to the U.S.—the threat of tariffs could resurface after the three-month cooling-off period. We have accordingly trimmed our 2019 growth forecast to 3.5%. A further downgrade would be necessary if the U.S. ramps up trade barriers enough as to significantly disrupt global trade volumes.

World: Growth is decelerating

Markit manufacturing PMI indices



NBF Economics and Strategy (data via Bloomberg)

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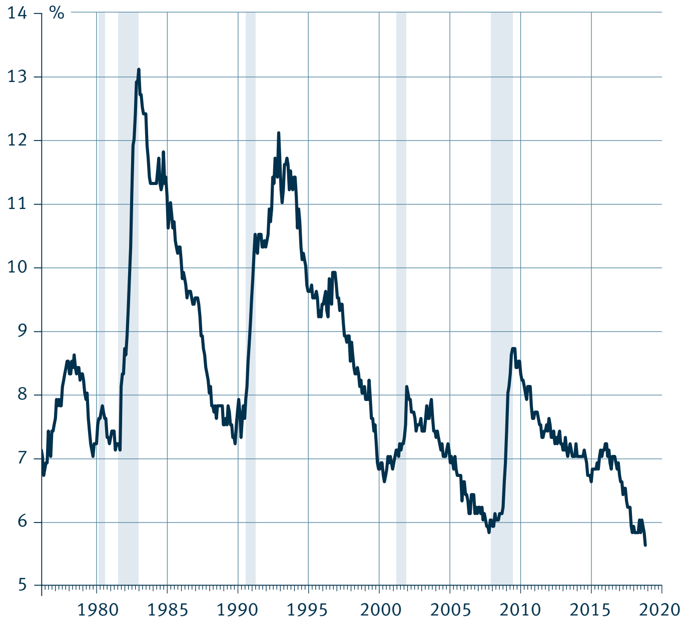
NATIONAL BANK FINANCIAL
WEALTH MANAGEMENT

Canada

As expected, the Canadian economy decelerated in Q3 after unsustainable gains in the prior quarter. Real GDP expanded at an annualized pace of 2.0% in the third quarter with contributions from trade (courtesy of rising exports and sinking imports), which more than offset drag from domestic demand. The latter was hurt by business investment and residential construction, which more than offset gains in government and consumption spending. Nominal GDP grew for an eleventh consecutive quarter, which will pad government coffers further. Looking further ahead to 2019, the loss of momentum for the global economy and oil production cuts mandated by Alberta's provincial government is a drag on growth. Consumers are also more vulnerable than first thought after Statistics Canada revised down the household savings rate. Not all is bleak, however. The jobless rate dropped to a record low, which supports labour income. Also, the federal government's *Fall Economic Statement*, which included measures allowing firms to lower their tax bills by accelerating depreciation of machinery, should help support business investment. We see the Canadian economy expanding 1.8% in 2019, roughly in-line with the Bank of Canada's estimate for potential GDP growth.

Canada: Perspective on labour-market slack

Unemployment rate



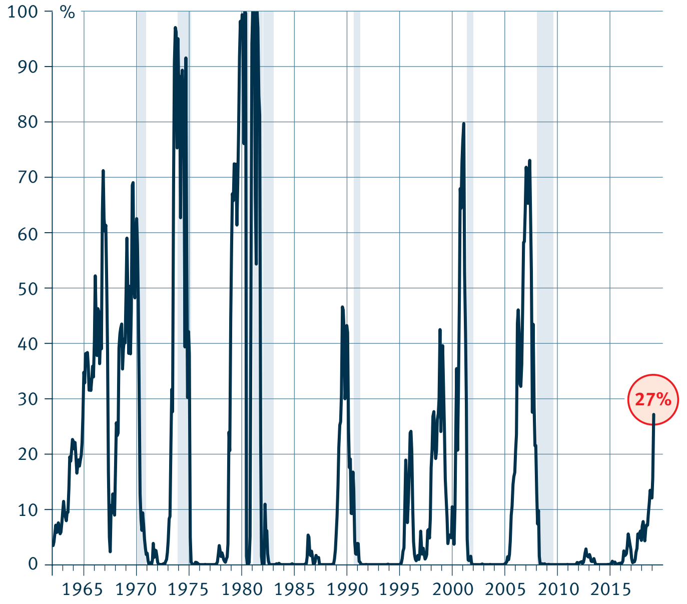
NBF Economics and Strategy (data via Statistics Canada)

United States

The U.S. economy continued to expand at a more than decent pace in the final quarter of 2018. At least that's the message from purchasing managers' indices being well above 50 and employment reports which continue to show gains in cyclical sectors such as manufacturing and construction, as well as record temporary employment. The labour market is getting tighter as evidenced by a jobless rate at 3.7%, the lowest since December 1969, and wages are accelerating as a result. Corporate profits also stand at a record high despite more evidenced of higher wage inflation. Despite this fairly benign outlook, U.S. equities continue to struggle at this writing as the yield curve has suddenly become very flat for this point in the cycle. Nonetheless, the chances of a U.S. recession over the next 12 to 18 months remains below the 50% threshold. Where we go from here is no longer as dependent on White House trade rhetoric (though calmer talk on that front would certainly help). We also need the U.S. Federal Reserve to adopt a more gradual approach to interest rate normalization. At this juncture, we still see the U.S. economy expanding 2.3% in 2019, down from 2.9% in 2018.

U.S.: Historical perspective on recession probability

Probability of recession based on the slope of the yield curve (10 year yield – 3 month yield)



NBF Economics and Strategy (data via Refinitiv)

Investment Strategy

The mix of an unpredictable U.S.-China trade brinkmanship, rising interest rates and fears of a global slowdown continued to weigh on investor sentiment in Q4, 2018, resulting in wild fluctuations and a somewhat disappointing performance for most asset classes. Though painful at times, it should not be forgotten that it is in the very nature of stock markets to experience bouts of heightened volatility and fear, and that it is during these periods that most opportunities typically arise, as long as the economy stays on track.

Stepping back from the daily gyrations, the reality is that fundamentals supporting growth in the economy and corporate profits remain in place. We acknowledge the fact that several U.S. economic indicators are at record levels, which leads many to believe that they can only go down from here. There is little doubt that many of these will soften over the coming quarters, as the boost from tax cuts gradually fades and the Fed's rate hikes prevent the economy from overheating. Still, slower growth is not an impediment to risk asset outperformance. The real threat is a recession, and the data simply does not suggest that this is a likely scenario in the near future.

That having been said, now is clearly not the time for complacency. The more we advance in the business and monetary policy cycle, the more things are going to become challenging, especially in this context of rising political uncertainty. But no matter how uncertain the future may be, the fact is that the 2018 contraction in equity valuations is of an amplitude almost only seen during recessions… at a time when the world economy is showing strong growth. Under these circumstances, we stand by our cautiously optimistic stance adopted earlier this year and continue to modestly favour equities over their fixed income alternatives. From a geographical standpoint, we also maintain our preference for U.S. equities, which should continue to benefit from a buoyant domestic economy, while European growth prospects pale in comparison.

The key factor to monitor in the coming months will be central banks' policy decisions, especially south of the border. The U.S. Federal Reserve has hiked interest rates no less than four times in 2018, thereby bringing its policy rate all the way up to 2.50%, the lower bound of what is generally perceived to be the neutral range. At this level, we expect the Fed to act with extra prudence as it balances the risks of moving too fast and shortening the expansion, or too slow and causing higher inflation or destabilizing financial imbalances. For now, inflation remains well in check, and the recent energy downturn, combined with lower import prices due to a higher U.S. dollar, should prevent it from accelerating much more. As such, we maintain our preference for shorter-duration products, as we expect global government bond yields to resume their upward trend once investor sentiment improves. We have, however, started reducing the risk in our fixed income portfolios recently to increase their effectiveness as a counterpoint to our equity overweight in an aging business cycle.

At home, crude oil woes did nothing to simplify the conduct of monetary policy in a country with such divergent economic realities from coast to coast. This, combined with the selloff in risk assets, caused the loonie to hit its lowest level since June 2017, a not-so-unfortunate outcome given the positive impact it has on investments denominated in foreign currencies. Looking ahead, we expect the Canadian dollar to regain some strength once risk aversion settles and the Bank of Canada catches up with its U.S. peer. Still, for this scenario to materialize, oil prices will have to recover some of the lost ground, which should be achieved through production cuts by the main oil-exporting countries.

MODEL PORTFOLIOS

Income Portfolio	Asset Class	Minimum/ Maximum	Benchmark	Recommended Weighting	Change from Previous Quarter
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%	6.0%	0.0%
	Fixed income (duration: 6.2 years)[1]	60% to 100%	70.0%	66.0%	0.0%
	Canadian equities	0% to 30%	8.0%	9.0%	0.0%
	U.S. equities		8.0%	10.0%	0.0%
	Foreign equities		4.0%	4.0%	0.0%
	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%	5.0%	0.0%
	Fixed income (duration: 6.2 years)[1]	45% to 80%	55.0%	51.0%	0.0%
	Canadian equities	20% to 45%	14.0%	15.5%	0.0%
	U.S. equities		14.0%	16.5%	0.0%
	Foreign equities		7.0%	7.0%	0.0%
	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%	5.0%	0.0%
	Fixed income (duration: 6.2 years)[1]	30% to 65%	40.0%	35.0%	0.0%
	Canadian equities	30% to 65%	18.0%	20.0%	0.0%
	U.S. equities		18.0%	21.0%	0.0%
	Foreign equities		9.0%	9.0%	0.0%
	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%	5.0%	0.0%
	Fixed income (duration: 6.2 years)[1]	20% to 45%	30.0%	26.0%	0.0%
	Canadian equities	40% to 75%	22.0%	23.5%	0.0%
	U.S. equities		22.0%	24.5%	0.0%
	Foreign equities		11.0%	11.0%	0.0%
	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%	5.0%	0.0%
	Fixed income (duration: 6.2 years)[1]	0% to 30%	15.0%	11.0%	0.0%
	Canadian equities	55% to 100%	26.0%	27.5%	0.0%
	U.S. equities		26.0%	28.5%	0.0%
	Foreign equities		13.0%	13.0%	0.0%
	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

			Forecast	
	2017	2018	2019	2020
Gross Domestic Product %				
Canada	3.0	2.1	1.8	1.7
U.S.	2.2	2.9	2.3	1.9
Inflation %				
Canada	1.6	2.3	2.1	2.2
U.S.	2.1	2.4	2.3	2.4

	December 2018		June 2018		December 2019	
	Canada	U.S.	Canada	U.S.	Canada	U.S.
Rate %						
Short-term rates (T-Bills, 91-Day)	1.68	2.45	2.18	2.72	2.46	2.93
10-year bond yields	2.19	3.00	2.44	3.31	2.93	3.48
30-year bond yields	2.28	3.39	2.52	3.54	3.00	3.69
Canadian dollar	US $0.76		US $0.79		US $0.78	

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