Asset Allocation

PRIVATE CLIENT SOLUTIONS

Investment Advisory Strategy Group (IASG) July 16, 2020

Quarterly Outlook

- As economies entered lockdown, aggregate demand fell off a cliff. However, governments and central banks acted quickly to limit the economic damage with unprecedented fiscal and monetary stimulus. In the US, Congress enacted a fiscal rescue package totalling US$2.8 tln with unprecedented speed, earmarking trillions for the unemployed and small businesses. Similarly, the US Federal Reserve (Fed) announced an open-ended quantitative easing program and several others to provide additional liquidity for market participants. This resulted in a significant expansion in its balance sheet of over US$3 tln. The Fed's actions helped to reduce the cost of borrowing for corporations and individuals, the lifeblood that keeps the economy growing. Combined, these measures amount to ~30% of US GDP.
- The stimulus, combined with a bottoming in the economic contraction, helped lift all assets in Q2. In the general risk-on environment, investors no longer sought the safety of the US dollar. This in turn put upward pressure on the Canadian dollar, which detracted from the US markets' strong quarterly returns. In CAD terms, the S&P/TSX Composite Index's total return managed to exceed the S&P 500 Index's due to the 3.5% appreciation in the Canadian dollar.
- The list of concerns and risks surrounding today's markets are many. However, capital must be invested and, in an environment where risk-free bonds offer little in the way of certain return, equities become the only game in town. By no means are equities riskless assets, but in a world where investors must choose between the two, the potential return profile of equities relative to bonds becomes more attractive. A simple comparison of the overall dividend yield of the S&P/TSX (3.4%) relative to the Canadian government 10-year yield (0.58%) shows a spread of 292 bps, indicating the relative attractiveness of equities compared to bonds. Considering central banks are committed to maintaining rates near zero until the economy fully recovers and/or employment levels reach acceptable levels, equities have essentially become the only asset class that can produce adequate returns for investors to achieve their investment objectives.

Please read domestic and foreign disclosure/risk information beginning on page 7

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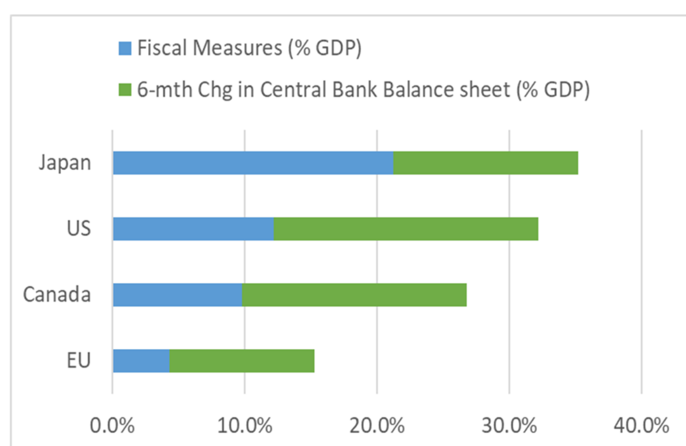
“Free” Money Makes the World Go Round

As economies entered lockdown, aggregate demand fell off a cliff. However, governments and central banks acted quickly to limit the economic damage with unprecedented fiscal and monetary stimulus. In the US, Congress enacted a fiscal rescue package totalling US$2.8 tln with unprecedented speed, earmarking trillions for the unemployed and small businesses. Similarly, the US Federal Reserve (Fed) announced an open-ended quantitative easing program and several others to provide additional liquidity for market participants. This resulted in a significant expansion in its balance sheet of over US$3 tln. The Fed’s actions helped to reduce the cost of borrowing for corporations and individuals, the lifeblood that keeps the economy growing. Combined, these measures amount to ~30% of US GDP. Of course, the US was not alone in announcing stimulus measures as there was a global fiscal and monetary response. The response to COVID-19 has far surpassed the measures taken during the financial crisis and, when combined with the monetary stimulus, these actions have been a significant contributor to the rebound in both equity and bond markets. Just like our global counterparts, the Canadian government also embarked on its own economic bailout package in an effort to keep the economy from slipping into a deep depression. Canada’s federal COVID-19 stimulus package has included spending more than $150 bln to help stabilize the economy, split between direct support to individuals and businesses. However, we now know that this year’s deficit will exceed $350 bln and the Bank of Canada’s balance sheet will expand beyond 20% of annual GDP.

Announced Global Fiscal & Monetary Measures (% of GDP)



Sources: www.statista.com, Raymond James Ltd.

While these measures limited the downside in the economy, both the US and Canada experienced a severe contraction. In Q1, US and Canadian GDP contracted at an annual rate of 5.0% and 8.2%, respectively; the unemployment rate shot up to 13.3% (in the US) and 12.8% (in Canada), putting millions of individuals out of work. The most severe impact from COVID-19 will be evident in Q2 GDP data released later this month. Nonetheless, as some normalcy returned in late Q2, economic growth began to rebound from very depressed levels. Still, the US recovery has been complicated due to rising COVID-19 cases across some 20 US states.

Atlanta Fed President Bostic (non-voter) has noted there has been a leveling off in high frequency data on business openings and mobility. Bostic notes trends were "troubling" and suggested the trajectory of the recovery is going to be bumpier than otherwise thought. He said the Atlanta Fed was attempting to determine whether the levelling off was temporary or part of a sustained pattern, adding that his biggest concern is the extent to which business and job losses become permanent.

This will put additional pressure on US Congress to deliver on their 5th relief bill; however, it will be no easy task as there have been growing policy differences between House Democrats and Senate Republicans. In addition, Republicans are having difficulty agreeing on contentious issues such as additional state and local government aid, enhanced unemployment benefits and another round of stimulus checks. Republicans are aiming for a US$1 tln or less package, while the Democrats are shooting for the stars with a ~US$3 tln package.

The current and future stimulus measures have provided a bridge for the economy while it recovers, but there remains uncertainty surrounding when the economy can fully reopen and support a robust recovery. The earliest both the US and Canadian economies may return to the previous level of GDP is 2022/23. In the meantime, governments and central banks will be encouraged to maintain ultra-accommodative fiscal and monetary policies until the economy fully recovers and/or acceptable levels of employment are achieved.

The stimulus, combined with a bottoming in the economic contraction, helped lift all assets in Q2. In the general risk-on environment, investors no longer sought the safety of the US dollar. This in turn put upward pressure on the Canadian dollar, which detracted from the US markets’ strong quarterly returns. In CAD terms, the S&P/TSX Composite Index’s total return managed to exceed the S&P 500 Index’s due to the 3.5% appreciation in the Canadian dollar.

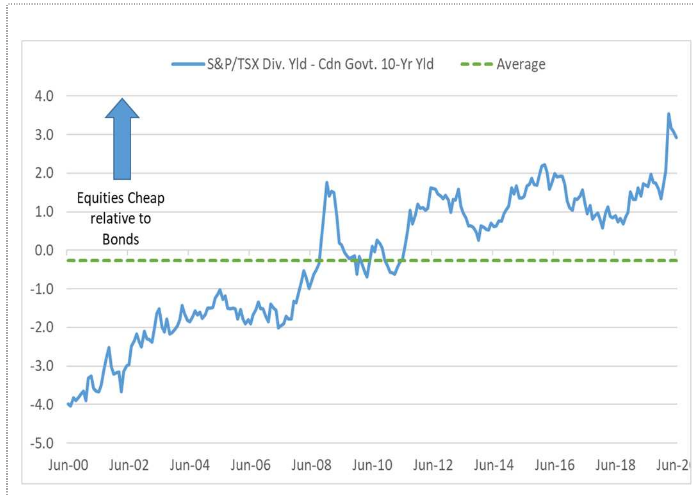
Q2/20 Asset Returns (in CAD)	Total Return
Canadian Equities (S&P/TSX)	17.0%
US Equities (S&P 500)	16.4%
International Equities (EAFE)	9.9%
Canadian Corporate Bonds	8.1%
Canadian Government Bonds	5.9%

Source: FactSet; Returns as of June 30, 2020

The "Nowhere To Go" Market

The list of concerns and risks surrounding today's markets are many. However, capital must be invested and, in an environment where risk-free bonds offer little in the way of certain return, equities become the only game in town. By no means are equities riskless assets, but in a world where investors must choose between the two, the potential return profile of equities relative to bonds becomes more attractive. A simple comparison of the overall dividend yield of the S&P/TSX (3.4%) relative to the Canadian government 10-year yield (0.58%) shows a spread of 292 bps, indicating the relative attractiveness of equities compared to bonds. Considering central banks are committed to maintaining rates near zero until the economy fully recovers and/or employment levels reach acceptable levels, equities have essentially become the only asset class that can produce adequate returns for investors to achieve their investment objectives.

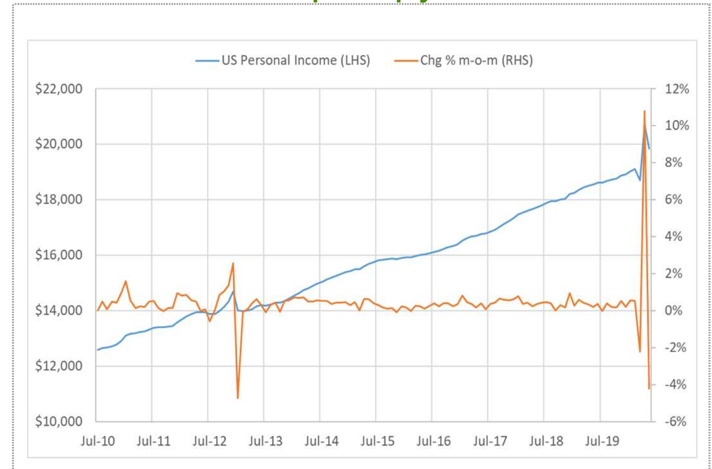
S&P/TSX Yield Relative to Cdn Govt. 10 Yr Yield



Source: FactSet, Raymond James Ltd.

We initiated a short-term tactical call to underweight equities in Q2 given the uncertainty facing the market and the rapid bounce off the March 23 bottom. As we move forward, we will be looking for an opportunity to reverse this short-term tactical call during the next two quarters, with the intension of moving it back to our long-term call (neutral equities). Despite the laundry list of risks facing the markets and economy, the lesson from the financial crisis was not to swim against the tide. As discussed, governments and central banks have shown an unprecedented commitment to do whatever it takes to keep the economy from faltering. In fact, this is the first time in history personal incomes actually *improved* during a recession thanks to the generous government fiscal relief packages targeted towards individuals. The sheer size of the fiscal and monetary stimulus and the indication that more will come, when needed, provides a significant tailwind for risk assets.

US Personal Income Up Sharply



Source: FactSet, Raymond James Ltd.

Our long-term allocation has remained neutral equities as we have been of the view that a significant bull market lies ahead. However, there was the anticipation the market would experience a bottoming process typically seen during recessionary periods. This type of bottoming appears more unlikely given the speed, willingness and size of stimulus being pumped into the global economy. The cautious view taken by us, and by others, has put substantial amounts of cash on the sidelines. At last count, some US$4 tln awaits to be deployed into the markets and, as this occurs, will help to extend the bull market, pushing valuation levels to similar extremes experienced in the late 1990s. We have already begun to see this extreme valuation within the NASDAQ. COVID-19 has helped to accelerate many technology trends established prior to the crisis by some 3-5 years, such as robotic automation, artificial intelligence and e-commerce. Investors have pushed the NASDAQ to new all-time highs, but the index has a heavy concentration in just five stocks. Microsoft, Apple, Amazon, Google and Facebook represent 45% of the index.

Concentration risk is one of the mixed signals we witnessed during Q2. Other risks included the CBOE VIX remaining elevated, strong performance of safe-haven precious metals and lack of participation from the banks. On the other hand, there were indications that pointed to a risk-on environment including improving copper prices, weakening US dollar, cyclicals outperforming defensives, a temporary rotation into value stocks and consumer discretionary/consumer staples ratio favouring improved prospects for consumer discretionary spending.

While the evidence is mixed, investors should be prepared for some setbacks during the recovery. Investor sentiment is overly bullish at the moment, although not at extremes, which may create volatility as economic data slows and the market deals with many headline risks over the next two quarters. However, given the factors mentioned above, any market weakness should be limited.

While economies experienced the initial reopening bounce, economic activity is now beginning to slow, as indicated by high frequency data on business openings and mobility. In the US, the number of COVID-19 cases is increasing, complicating the recovery as 20 US states, covering about 40% of the US population, are now reversing or slowing their reopening plans. This will have some negative impact on economic output, but not nearly as severe as the initial lockdown. If some states/cities must again enter a lockdown they should be localized, and thus the economic fallout largely contained. Nonetheless, politicians will be under pressure to deliver another stimulus package.

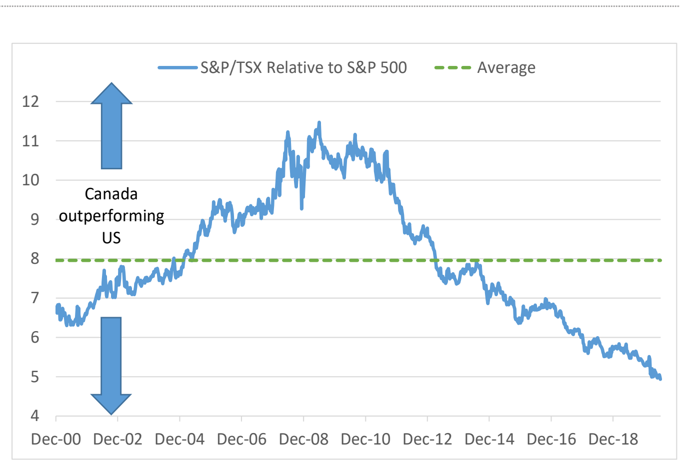
As we look to move our short-term allocation in equities back to neutral it will not be without risk. Increasing exposure to equities must come with the recognition that government stimulus and central bank liquidity trumps economic growth and activity at this time, and that their actions will remain in place until a robust recovery is established.

Regional Exposure & Currency

Regional exposures make a difference. The Canadian market, like many other developed markets, has underperformed the US (in local terms). In the decade after the financial crisis, a similar scenario played out with US equities producing significant outperformance relative to most developed markets. The strong US equity returns has now pushed the US equities weighting in the MSCI World index to ~66%. While predicting the next six months will be difficult (let alone the next 10 years), we believe that we are likely to see a similar dynamic play out where US equities provide significant outperformance. As such, we recommend Canadian investors overweight the US at the expense of Canada and international exposure, but hedge the currency risk where possible.

In the short term, the Canadian dollar appears range bound between 1.32-1.37 with breaks to the upside more likely (weaker CAD). Further out, we would expect US dollar strength to wane due to decreasing foreign demand for US dollars. However, loonie appreciation against USD will be limited relative to global peers as investors begin to focus on country-specific risks such as consumer debt levels, elevated housing contribution to GDP growth and challenged energy markets.

Canada/US Ratio



Source: FactSet, Raymond James Ltd.

Fixed Income

In terms of our long-term fixed income recommendation, we remain underweight as low rates within this asset class offer little in the way of return. Broadly, we prefer governments over corporates as a way to buy insurance from market volatility. Within corporates, there are select opportunities which adept bond managers can exploit, but from a high level we believe spreads should widen as central bank support is removed. When it comes to generating absolute yield, 1-5 year GIC rates offer the best value, but come with the obvious caveat of no liquidity. For those looking for increased duration, we believe the best course would be to buy a 1-5 year GIC ladder and then complement that with a 1-10 year ladder strategy consisting of high quality corporates, Provincial and Treasury bonds.

Short-term Allocation

We recommend a moderate investor with a short time horizon maintain to the following allocation:

- Underweight equities at 45%
- Overweight cash at 10%
- Neutral bonds at 45%

Long-term Allocation

For long-term investors, we maintain our current allocation with the anticipation of moving cash to neutral over the next several quarters. Given the significant amounts of stimulus in the system and pent up demand, we anticipate a rather significant and robust recovery post-COVID-19. Our current asset allocation for the moderate investor profile remains:

- Neutral equities at 50%

- Overweight cash at 10%
- Underweight bonds at 40%

Recession Checklist

The unprecedented measures taken by central banks and governments has flipped many of the indicators below from recessionary to expansionary. For example, support for credit markets in the form of buying corporate debt significantly eases credit spreads and the drop of short-term rates steepened the yield curve. As such, our “US Recession Checklist” in the table below shows an improvement is some of the seven key economic indicators both in the overall reading and the trend.

US Recession Checklist

Start of Recession	Yield Curve	Inflation Trend	Labour Market	Housing Market	Consumer Confidence	ISM Manufac.	Hi Yield Spread
Nov-73	▼	▼	▼	▼	▼	▼	▼
Jan-80	▼	▼	▼	▼	◄►	▼	▼
Jul-81	▼	▲	▲	▼	▼	▼	▼
Jul-90	▼	▼	▼	▼	▼	▼	▼
Mar-01	▼	▼	▼	◄►	▼	▼	▼
Dec-07	▼	▼	◄►	▼	◄►	▼	▼
Current	▲	◄►	▼	◄►	▼	▲	▲
Trend	Positive	Neutral	Positive	Neutral	Neutral	Positive	Neutral

Source: FactSet, Raymond James Ltd.

Asset Class	Recommendation	Comments
Equities	**Neutral**	No change for long term investors, but over the short term we see downside. From a long-term view, record monetary/fiscal stimulus and relative equity/bond valuation points to positive bias towards equities.
Large Cap	+	Preference for large over mid- to small-caps due to large-caps' inherent ability to sustain an uncertain economic environment.
Quality	+	Preference for quality due to quality's inherent ability to sustain an uncertain economic environment.
Growth	+	Preference for growth given their ability to display sector-leading revenue and earnings growth.
Value	-	
Defensive	+	Favour companies with revenue and earnings visibility.
Cyclical	-	
Bonds	**Underweight**	This one is tricky – bonds are overvalued versus stocks, although you could have made the same case for much of 2019. Central bank QE programs are supportive of bond markets, including corporates, however, from a long-term perspective, we believe equities are relatively more attractive.
Government	+	We see value in owning both government bonds for safety and quality corporates given the BoC's support of the market. Specifically related to government bonds, the BoC's bond buying program ($50 bln) includes provincial bonds with maturities less than 10 years.
Corp	-	Select quality corporates are attractive considering spreads have widened significantly. The BoC's bond buying program ($10 bln) includes corporates BBB rated and above with maturities less than 5 yrs.
Duration	Short to medium	There is very little pick up to move far out on the curve. The furthest we'd look to go is in the middle of the curve.
Cash	**Overweight**	Cash is king in uncertain times.
Regional Allocation		
Canada	-	
US	+	Add US exposure, but on a hedged basis.
Int'l	-	Weaker USD will benefit EM. Valuation levels are more attractive outside North America, within EM focus on China.

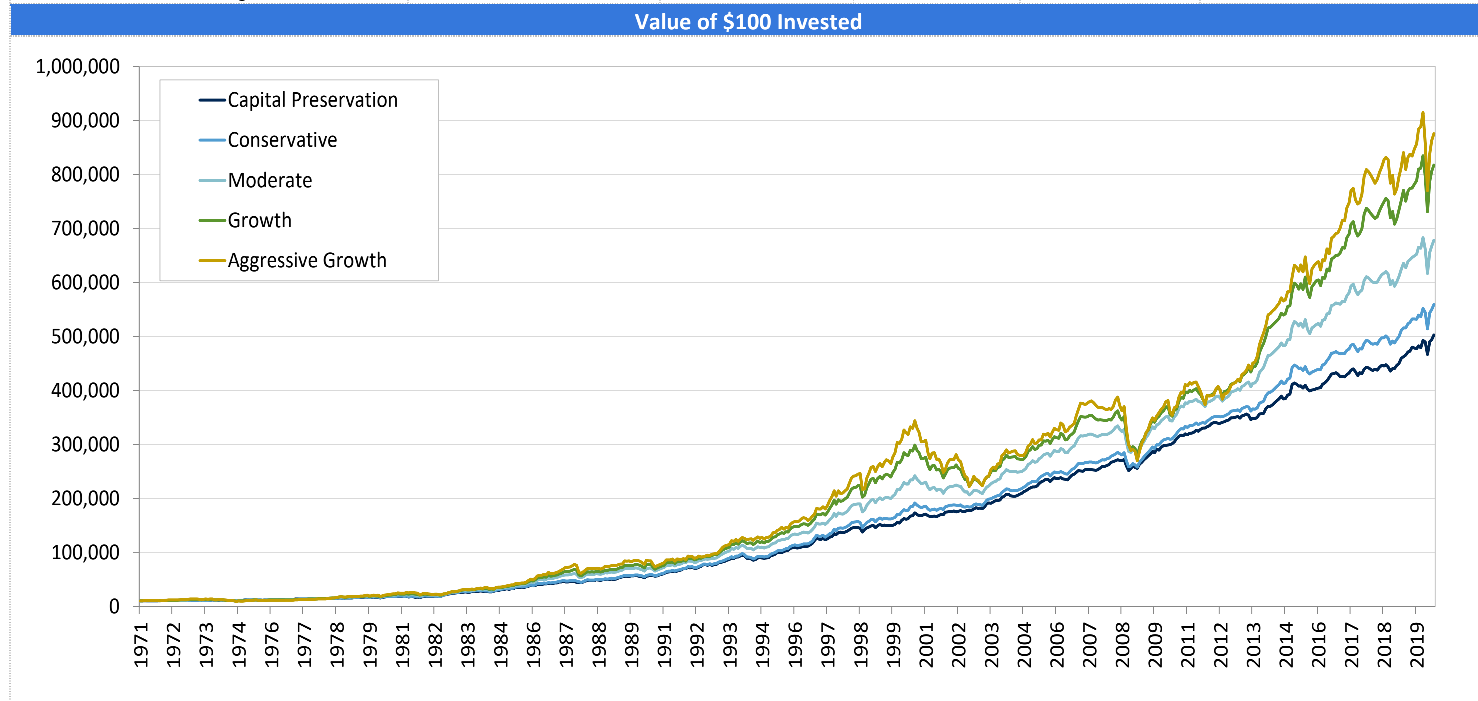
Investor Profiles and Asset Class Weightings

Recommended Asset Allocation	Capital Preservation	Conservative	Moderate	Growth	Aggressive Growth
Cash	8%	8%	10%	10%	8%
Bonds	72%	62%	40%	20%	2%
Can Equities	15%	15%	15%	20%	25%
US Equities	5%	15%	25%	35%	45%
Intl Equities	0%	0%	10%	15%	20%
	100%	*100%*	*100%*	*100%*	*100%*
Tactical Asset Mix (Bonds include cash)					
Bonds | Equities	80 | 20	70 | 30	50 | 50	30 | 70	10 | 90
Strategic Asset Mix (Bonds include cash)					
Bonds | Equities	80 | 20	70 | 30	50 | 50	30 | 70	10 | 90
Asset Ranges					
Cash	0-20	0-20	0-20	0-20	0-20
Bonds	60-100	50-90	20-70	10-50	0-30
Equities	0-30	10-50	30-75	50-90	70-100
Description	May be appropriate for investors with long-term income distribution needs who are sensitive to short-term losses. The equity portion of this portfolio generates capital appreciation, which is appropriate for investors who are sensitive to the effects of market fluctuation but need to sustain purchasing power. This portfolio, which invests primarily in fixed-income securities, seeks to keep investors ahead of the effects of inflation with an eye toward maintaining principal stability.	May be appropriate for investors with intermediate-term time horizons who are sensitive to short-term losses yet want to participate in the long-term growth of financial markets. The portfolio, which fixed-income securities tend to make up the largest proportion of holdings, seeks to keep investors well ahead of the effects of inflation with an eye toward maintaining principal stability. The portfolio has characteristics that may deliver returns lower than that of the broader market with lower levels of risk and volatility.	May be appropriate for investors seeking a balance between capital preservation and capital growth. This portfolio, which is a split between fixed-income securities and equities, seeks to keep investors well ahead of the effects of inflation with an eye toward maintaining principal stability. With roughly half of the portfolio invested in a diversified mix of Canadian and international equities, investors should be comfortable with moderate fluctuations in the portfolios.	May be appropriate for investors with long-term time horizons who are not sensitive to short-term losses and want to participate in the long-term growth of the financial markets. This portfolio, which has a higher weighting in equities, seeks to keep investors well ahead of the effects of inflation with principal stability as a secondary consideration.	May be appropriate for investors with long-term time horizons who are not sensitive to short-term losses and want to participate in the long-term growth of the financial markets. This portfolio, which is primarily invested in equities, seeks to keep investors well ahead of the effects of inflation with little regard for maintaining principal stability. The portfolio may deliver returns comparable to those of the broader equity market with similar levels of risk and volatility.

Client Profile Statistics

	Capital Preservation	Conservative	Moderate	Growth	Aggressive Growth
Total Return (annualized)	8.2%	8.5%	8.9%	9.3%	9.5%
Avg Monthly Return	0.68%	0.70%	0.74%	0.78%	0.81%
Avg Rolling 12 Month Return	8.5%	8.7%	9.2%	9.8%	10.2%
Annualized Std Dev (36 months)	5.4%	6.1%	7.4%	9.4%	11.5%
Sharpe Ratio	1.5	1.4	1.2	1.0	0.8
Best 12 month Rolling return	46.5%	48.0%	46.1%	46.3%	47.7%
Worst 12 month Rolling Return	-7.7%	-11.3%	-18.9%	-26.1%	-32.6%

Value of $100 Invested



Source: FactSet, Raymond James Ltd. As at June 30, 2020, Inception January 1971.

Performance statistics are calculated using C$ monthly returns that are rebalanced every calendar year using the recommended asset class weightings for each profile (cash weighting has been rolled up into the bond weighting).
Benchmarks: Bonds = FTSE/TMX Canada Universe Bond TR Index; Canadian Equities = S&P/TSX Composite TR Index, US Equities = S&P 500 TR Index; International Equities = MSCI EAFE TR Index.

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