# Asset Allocation

PRIVATE CLIENT SOLUTIONS



## Quarterly Outlook: Equities to Overweight

- Global purchasing managers' indices (PMI) have firmly moved into expansionary territory indicating positive growth momentum for the broader global economy. Beneath the headline figure, the most recent reading showed new orders and net jobs increased for the first time since January. **Bottom line:** *economic data has improved dramatically and forward looking components points to further economic gains*

- US corporate earnings revisions have turned positive. An above-average number of S&P 500 companies have issued positive EPS guidance for Q3/20 at this point, with the percentage of positive EPS guidance at 67% compared to the 5-year average of 32%. For the full year 2020, analysts are no longer marking down earnings as this trend bottomed in July and has since reversed course. We see a similar pattern emerging for the full year 2021; analysts are now projecting earnings growth of over 25% on revenue growth of 8.0%. **Bottom line:** *the worst of the earnings decline is in the in past; corporations and analysts are more upbeat than a few weeks ago.*

- Governments and central banks have shown their willingness to do whatever it takes to keep the economy (and the equity markets) afloat. In the past 30 years alone, there have been varying degrees of economic bailouts occurring every ~10 years: Long Term Capital Management in the late 1990s, the airline industry after 9/11, the US banking, mortgage, insurance and auto industry in 2008/2009 and the entire economy in 2020. The latest is the largest yet and puts the great financial crisis response to shame not only in term of magnitude but the speed at which it was implemented. **Bottom line:** *swimming against a tsunami of liquidity is a losing proposition and there are additional levers the Fed can pull during periods of market turbulence. Don't fight the Fed!*

- Investors must place capital to earn a rate of return. In the broadest sense, investors must choose between two options – equities or bonds. Unfortunately, the days of earning a mid-single-digit return in relatively "safe" bonds are well behind us. **Bottom line:** *Equity Risk premium suggests equities are attractively valued relative to bonds.*

- While cash is king in uncertain times, earning virtually nothing on cash holdings over a long period can result in a negative real return once inflation is taken into account. **Bottom line:** *after inflation, cash earns a negative real return.* .

- We have maintained our long-term neutral call on equities since Q4 2018. Given the reasons we've outlined above we are removing our short-term call on equities while also moving our long-term view to overweight. In a nutshell, we reduce cash from overweight to neutral in order to fund increasing equity exposure.

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

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## Onward and Upward

In this note, we reflect on our decision making process and outline why we are more constructive on equities heading into 2021. Before we look forward, it's useful to reflect on the past. We took a more cautious view on equities in Q4/2018, downgrading to neutral citing a deceleration in global economic activity and a US Federal Reserve (Fed) that was hell bent on continuing to normalize interest rates. A sharp sell off in world equity markets quickly shifted most central banks from a tightening to loosening stance, helping to lift world equity markets to double-digit returns in 2019. It was not until late in 2019 that there was clear evidence the global economy was on the mend, but of course this was occurring within the context of the longest economic expansion in US history and with bond markets signalling tougher times were ahead (during the summer of 2019 over $16 tln in bonds traded with a negative yield). Just as economic conditions appeared to brighten, along came the global pandemic and the self-induced economic lockdown. The recession that occurred saw the steepest drop in economic activity on record; the policy response had to be substantial and it was. The unprecedented fiscal and monetary stimulus quickly reversed the steep contraction and the implicit backstop for risk assets quickly reversed the damage in equities markets.

Using historical references for recessions and bear markets suggested we had time to move our equity allocation back to overweight. History did not serve us well in this case, as equity markets staged a historic recovery with some markets achieving new record highs. To put this recovery into context the table below breaks down the six market recoveries from a 30%+ decline in the S&P 500 since WWII. The February sell off was the shortest in duration at 1.1 months followed by the 1987 crash as the next shortest 30%+ drop in the index. With the S&P 500 making a new highs, it marks the quickest recovery from the lows at 4.7 months; the median is 48.6 months. History has been made!

**S&P 500 30%+ Declines & Rebounds**

| Peak | Bottom | Peak to Bottom (mth) | Peak to Bottom Chg | Bottom to New High (mth) | Peak to New High (mth) |
|---|---|---|---|---|---|
| Nov. 29, 1968 | May 26, 1970 | 17.8 | -36.1% | 21.4 | 39.2 |
| Jan. 11, 1973 | Oct. 3, 1974 | 20.7 | -48.2% | 69.5 | 90.2 |
| Aug. 25, 1987 | Dec. 4, 1987 | 3.3 | -33.5% | 19.7 | 23.0 |
| Mar. 24, 2000 | Oct. 9, 2002 | 30.5 | -49.2% | 55.7 | 86.2 |
| Oct. 9, 2007 | Mar. 9, 2009 | 17.0 | -56.8% | 48.6 | 65.6 |
| Feb. 19, 2020 | Mar. 23, 2020 | 1.1 | -33.9% | 4.7 | 5.8 |

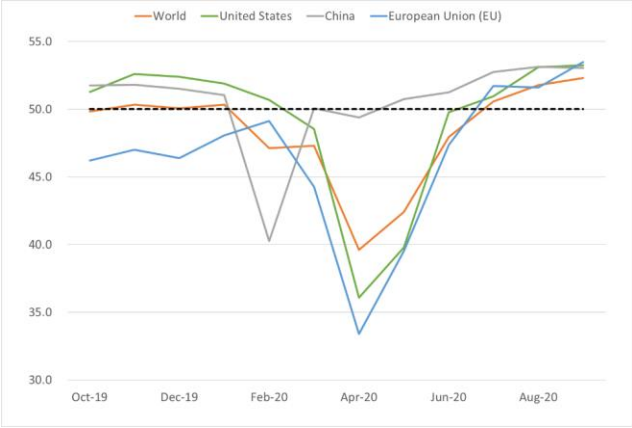
Source: FactSet, Raymond James Ltd.

While there is a laundry list of reasons to remain cautious, we believe the pros outweigh the cons particularly for investors with a long-term investment horizon. In this quarterly outlook we walk through the reasons we are moving equities to overweight.

## Global Economic Data Improving

Global purchasing managers' indices (PMI) have firmly moved into expansionary territory indicating positive growth momentum for the broader global economy. Beneath the headline figure, the most recent reading showed new orders and net jobs increased for the first time since January. However, the overall pace of output growth has edged lower and business sentiment slipped for a second month amid growing second-wave worries. While rising COVID-19 cases will provide a near-term headwind for growth we do not anticipate it to be nearly as disruptive to the economy as it was in March. Consumers and businesses have made the necessary adjustments and governments stand ready to support the growth outlook. In the US, Democrats are pushing for a stimulus package worth $2.2 tln, while Republicans have proposed a package worth $1.6 tln. It's simply a matter of time for the additional fiscal spending to be unleashed on the economy. A finalized bill is anticipated to be signed into law shortly after the US election.

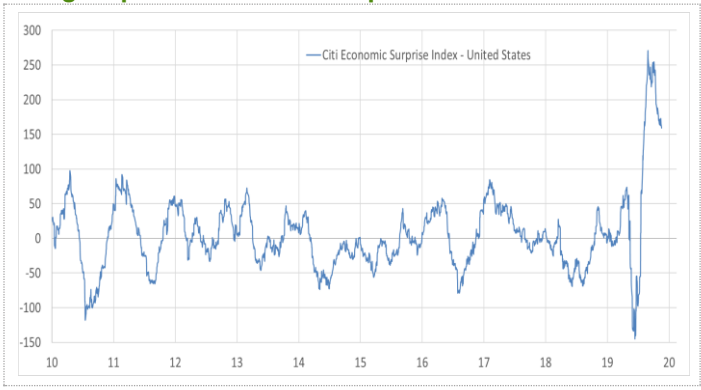
**Global PMI Back in Expansion Territory**




Source: FactSet, Raymond James Ltd.

The impact of the earlier relief packages can also been seen in a broad set of economic measures. The Citigroup Economic Surprise Index measures economic data surprises (actual releases versus consensus), where a positive reading suggests that economic releases have on balance been beating consensus. As one can see in the next chart economic data releases have been remarkably strong, surpassing economists' expectations by a wide margin. In fact, the Citigroup US economic surprise index surged to a record high surpassing the previous peak hit in 2009. While the gauge has pulled back slightly over the past week, it has managed to sustain gains since reaching positive territory in June.

### Citigroup US Economic Surprise



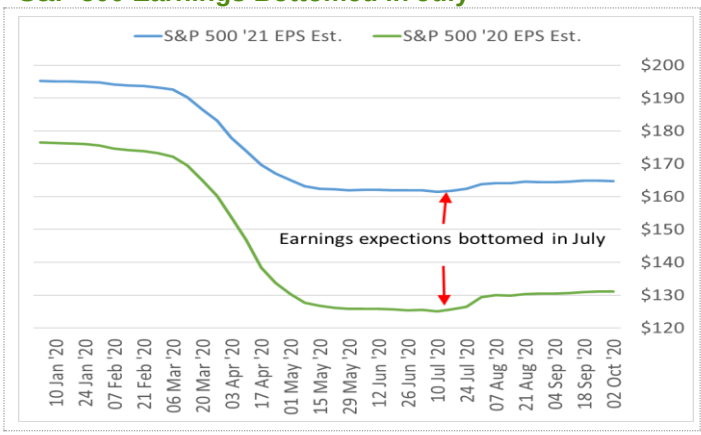

Source: FactSet, Raymond James Ltd.

**Bottom line:** *economic data has improved dramatically and forward looking components points to further economic gains.*

## Corporate Earnings Revisions

US corporate earnings revisions have turned positive. An above-average number of S&P 500 companies have issued positive EPS guidance for Q3/20 at this point, with the percentage of positive EPS guidance at 67% compared to the 5-year average of 32%. For the full year 2020, analysts are no longer marking down earnings as this trend bottomed in July and has since reversed course. We see a similar pattern emerging for the full year 2021; analysts are now projecting earnings growth of over 25% on revenue growth of 8.0%. Even if these numbers are revised lower throughout the coming year, it's hard to ignore an asset class that is growing at a double-digit rate.

### S&P 500 Earnings Bottomed in July



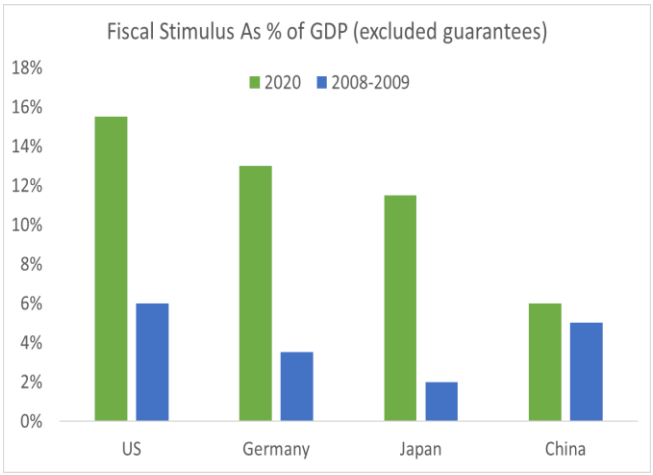

Source: FactSet, Raymond James Ltd.

**Bottom line:** *the worst of the earnings decline is in the in past; corporations and analysts are more upbeat than a few weeks ago.*

## Record Stimulus

Governments and central banks have shown their willingness to do whatever it takes to keep the economy (and the equity markets) afloat. Forced between taking no action and taking aggressive action, the option taken is always to do more to avoid severe negative outcomes. In the past 30 years alone, there have been varying degrees of economic bailouts occurring every ~10 years: Long Term Capital Management in the late 1990s, the airline industry after 9/11, the US banking, mortgage, insurance and auto industry in 2008/2009 and the entire economy in 2020. The latest is the largest yet and puts the great financial crisis response to shame not only in term of magnitude but the speed at which it was implemented. We suppose after 30 years of practice officials have gotten it down to a science.

### Fiscal COVID-19 Response vs Great Financial Crisis




Source: Government agencies, IMF, Raymond James Ltd.

The double-barrel approach is most effective. As such, central banks also supported markets with massive asset purchase programs directed towards both government and corporate bonds. In the US, the Federal Reserve announced an open-ended quantitative easing program and several other measures to provide additional liquidity for market participants. This has resulted in a significant expansion in the Fed's balance sheet swelling to just over US$ 7.0 tln. From a market perspective, these backstops signal that risk assets are *less* risky (note emphasis, equities are inherently risky) as market disruptions will be met with full authority of the Fed. Of course this statement is only true as long as we all have faith in our institutions to continue providing support when they deem necessary.

### Fed's Balance Sheet Explodes Higher


Source: FactSet, Raymond James Ltd.

**Bottom line:** *swimming against a tsunami of liquidity is a losing proposition and there are additional levers the Fed can pull during periods of market turbulence. Don't fight the Fed!*

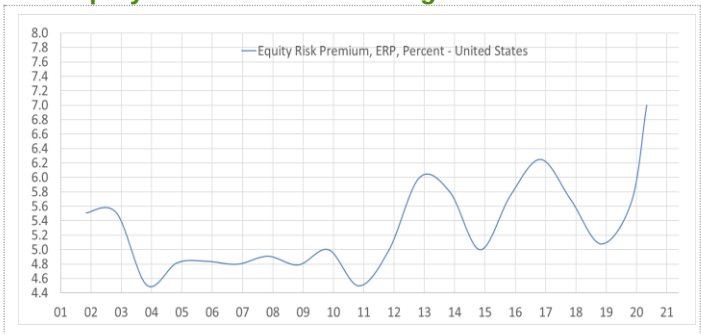
## Equity Relative to Bonds Attractive

Investors must place capital to earn a rate of return. In the broadest sense, investors must choose between two options – equities or bonds. Unfortunately, the days of earning a mid-single-digit return in relatively "safe" bonds are well behind us. Today, government bonds offer very little in the way of income and after inflation investors are likely to earn a negative real rate of return. The equity market on the other hand presents investors with the opportunity to participate in the growing earnings, cash flow and dividends of a corporation, increasing the chance of earning a positive real return but with added risk. To compare the relative attractiveness of the two asset classes, one can simply look at the dividend yield versus the yield on a benchmark bond. For example, the S&P 500 yields 1.7% while the US 10 year government bond yields 0.8%. If you bought and held the two assets for 10 years, the cumulative return (ignoring compounding and capital appreciation/depreciation) would be 17% and 8%, respectively. The likelihood that equities would appreciate over the next decade is considerably higher than zero, which is what you're getting with a bond (considering rolling 10 year monthly price returns for the S&P 500 since 1930, a negative return occurred ~12% of the time with an average annualized loss of 3.2%).

Another way to look at stocks' relative attractiveness is the equity risk premium. This is the return earned above a risk-free investment such as US treasuries. A higher equity risk premium (ERP) would indicate investors require a larger expected return from stocks to compensate for the added risk they are taking. A lower premium would indicate stocks are viewed as less risky and thus investors demand less of a cushion.

Given the current environment with central banks committed to maintain rates at ultra-low levels for the foreseeable future, and governments willing to provide stimulus to support economic growth, a lower ERP is warranted. The average US ERP since 1991 has been calculated at 5.4; today the premium is closer to 7.9.

### US Equity Risk Premium Too High




Source: FactSet, Raymond James Ltd.

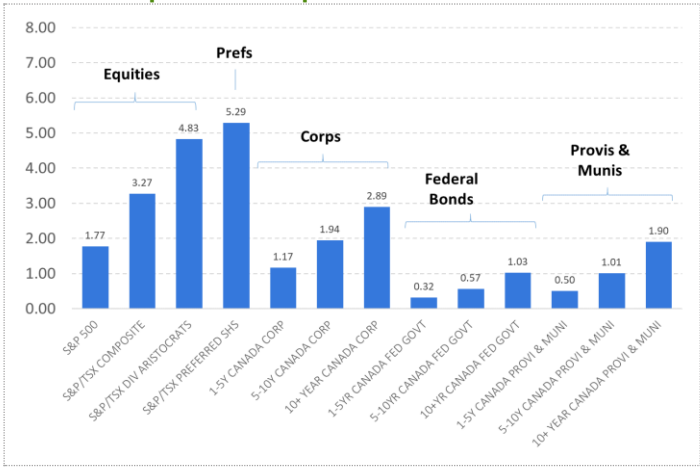
**Bottom line:** *ERP suggests equities are attractively valued relative to bonds.*

## Cash Offers Little Return

While cash is king in uncertain times, earning virtually nothing on cash holdings over a long period can result in a negative real return once inflation is taken into account. Even looking at other fixed income categories reveals how difficult it is for investors to earn a real rate of return. In order to do so, investors are increasingly being pushed to either take on more risk via credit (corporate bonds), extend duration (moving further out on the yield curve) or consider an entirely different asset class. Maintaining an overweight cash position in this environment is clearly a losing proposition.

**Bottom line:** *after inflation, cash earns a negative real return.*

### Yield Comparison – Equities vs Bonds




Source: FactSet, Raymond James Ltd.

## Asset Allocation Changes

We have maintained our long-term neutral call on equities since Q4 2018. Given the reasons we've outlined above we are removing our short-term call on equities while also moving our long-term view to overweight. In a nutshell, we reduce cash from overweight to neutral in order to fund increasing equity exposure.

In terms of investment style we continue to recommend a focus on large-cap quality growth stocks, but note value as a style is trading at a very significant discount to growth. We move our defensive/cyclicals preference to neutral as it is increasingly difficult to distinguish between these two categories in the current environment. For example, technology, a cyclical sector, is behaving more like a defensive sector. We made no changes from a regional perspective as we continue to believe that US equities will outperform most developed markets.

Within fixed income, we no longer favour government over corporate bonds. We believe investors can continue to hold government bonds due to the diversification benefits they exhibit (low correlation to equities), but investors should not anticipate much in the way of return particularly once inflation is included. We view corporate bonds as an area for investors to earn income, however their correlation to equities have increased in recent years thus reducing their diversification benefits. In the following table, we can see how correlations have changed over time. From 2010 to 2015, bonds exhibited a negative correlation to equities; from 2015 to today the correlation has creeped higher, particularly for corporate bonds which are now showing a significant positive correlation to equities. Additionally, spreads have narrowed significantly since central banks begun buying corporate bond issues so investors should be selective when deploying capital.

**Correlation of Bonds to S&P/TSX Index**

| Type | Duration | 2010-15 | 2015-20 |
|---|---|---|---|
| Aggregate Bonds | 1-5YR | -0.20 | 0.13 |
| | 5-10YR | -0.16 | 0.15 |
| | 10+ YR | -0.17 | 0.36 |
| Corporates | 1-5YR | -0.04 | 0.61 |
| | 5-10YR | 0.00 | 0.58 |
| | 10+ YR | -0.07 | 0.58 |
| Federal Govt. | 1-5YR | -0.29 | -0.32 |
| | 5-10YR | -0.26 | -0.20 |
| | 10+ YR | -0.29 | -0.03 |
| Provi & Muni | 1-5YR | -0.23 | -0.13 |
| | 5-10YR | -0.18 | 0.10 |
| | 10+ YR | -0.14 | 0.38 |

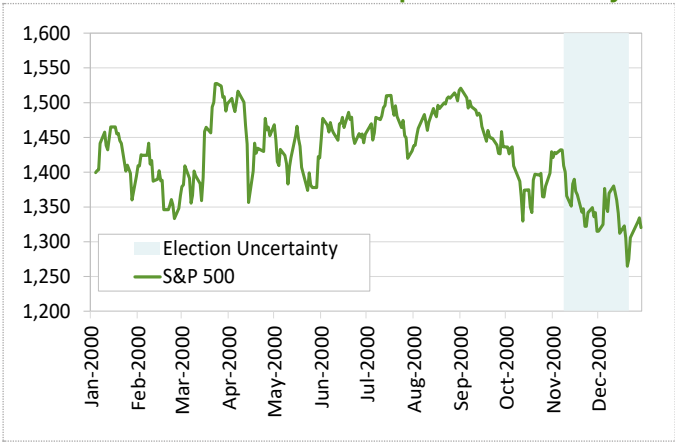
Source: FactSet, Raymond James Ltd. Based on monthly returns

## Risk

The largest near-term event risk is clearly the US election. It's consensus that the election results will not be known on November 3; from a contrarian standpoint we believe this creates an opportunity to move ahead of the election uncertainty, particularly if the election is won decisively by one of the candidates on election night. If we recall the 2016 election, markets have a tendency to overreact to election results. When it was clear Trump had won, equity futures were deep in the red, but as the realization that lower taxes and deregulation was good for corporate profits the market staged a significant recovery and ended higher on the day. Either way, the outcome of the election will have little impact on the long-term trajectory of the markets, but on the margin there will be sectors and specific areas to focus on depending on who is elected.

Investors that are concerned about the volatility around the election or are less tolerant to risk may choose to wait for the election uncertainty to subside. This is understandable as the last US election that was too close to call, and ultimately had to be decided by the Supreme Court, was in 2000. Florida was the battle ground, a state where George W. Bush won by a slim margin over Al Gore. Given the margin, state law required a recount and resulted in a month-long legal battle which ended in a 5-4 Supreme Court ruling in favour of Bush. Equity markets did not perform well during this period, but we also highlight there may have been other mitigating factors in play, such as the bursting of the dot.com bubble and impending US recession.

**US 2000 Election – S&P 500 Slips on Uncertainty**

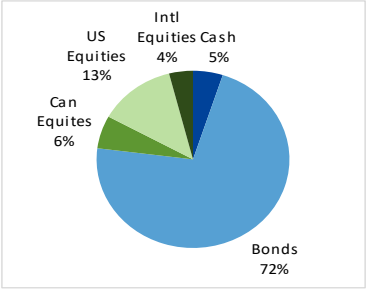
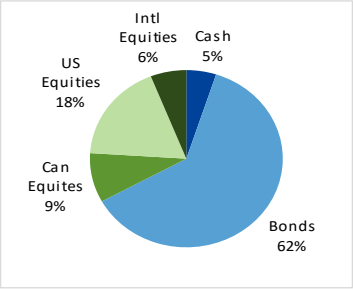
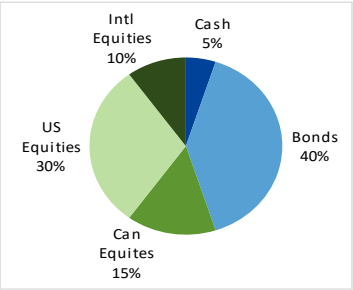
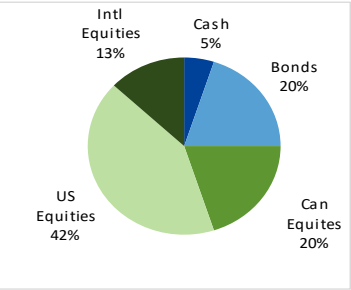
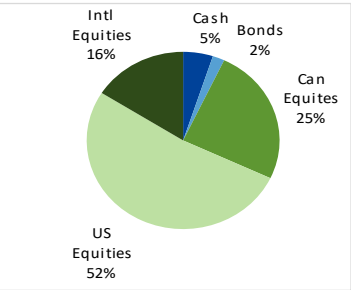



Source: FactSet, Raymond James Ltd.

| Asset Class | Recommended Allocation | | | | | Summary |
|---|---|---|---|---|---|---|
| | - | | | | + | |
| **Equities** | | | | | | **Overweight** |
| *Large Cap* | | | | | | From a long-term view, record monetary/fiscal stimulus and relative equity/bond valuation points to a positive bias towards equities. We favour large-cap quality growth stocks but note value is trading at a significant discount to growth presenting an opportunity to begin accumulating quality value stocks. Traditional cyclical areas are acting defensively (technology) making the defense/cyclical distinction muddled. Focus on companies with defensive attributes, strong balance sheet strength, free cash flow and good earnings visibility. |
| *Small Cap* | | | | | | |
| *Quality* | | | | | | |
| *Junk* | | | | | | |
| *Growth* | | | | | | |
| *Value* | | | | | | |
| *Defensive* | | | | | | |
| *Cyclical* | | | | | | |
| **Bonds** | | | | | | **Underweight** |
| *Government* | | | | | | We recommend an allocation to government bonds given their low correlation to equities and allocating to corporates to generate income. We would focus on short- to medium-term maturities. Investors concerned about future inflation can consider US TIPs and/or Canadian real return bonds. |
| *Corp* | | | | | | |
| *Duration (short)* | | | | | | |
| *Duration (med)* | | | | | | |
| *Duration (long)* | | | | | | |
| *Alternatives* | | | | | | Alternative investments are unique and an allocation to the segment is highly dependent on a client's investment objectives, time horizon, liquidity needs and risk tolerance. Given the various factors that differentiate Alternatives from traditional investments, we recommend a more holistic approach wherein investors tailor certain funds from our Approved List to meet their needs. |
| **Cash** | | | | | | **Neutral** |
| **Regional Allocation** | | | | | | |
| *Canada* | | | | | | The US fiscal and monetary response provides a significant tailwind for US equities. We would favour US exposure over other regions, but note valuation levels are more attractive outside North America. Within emerging markets we'd focus on China. |
| *US* | | | | | | |
| *Int'l* | | | | | | |

# Investor Profiles and Asset Class Weightings

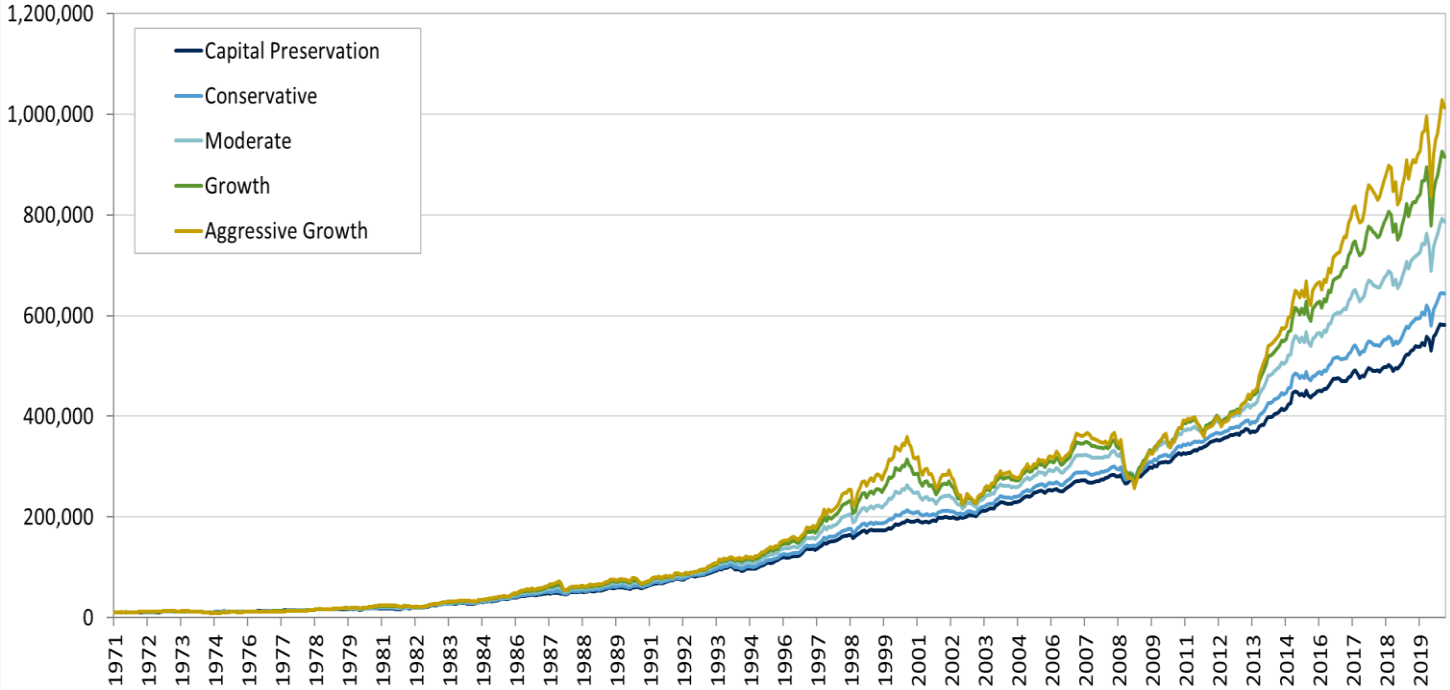
**Recommended Asset Allocation**

| | Capital Preservation | Conservative | Moderate | Growth | Aggressive Growth |
|---|---|---|---|---|---|
| |   |   |   |   |   |
| Cash | 5% | 5% | 5% | 5% | 5% |
| Bonds | 72% | 62% | 40% | 20% | 2% |
| Can Equities | 6% | 9% | 15% | 20% | 25% |
| US Equities | 13% | 18% | 30% | 42% | 52% |
| Intl Equities | 4% | 6% | 10% | 13% | 16% |
| | *100%* | *100%* | *100%* | *100%* | *100%* |
| **Tactical Asset Mix (Bonds include cash)** | | | | | |
| Bonds \| Equities | 77 \| 23 | 67 \| 33 | 45 \| 55 | 25 \| 75 | 7 \| 93 |
| **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)** | 8.5% | 8.7% | 9.2% | 9.5% | 9.7% |
| **Avg Monthly Return** | 0.70% | 0.72% | 0.76% | 0.80% | 0.83% |
| **Avg Rolling 12 Month Return** | 8.7% | 9.0% | 9.5% | 10.0% | 10.5% |
| **Annualized Std Dev (36 months)** | 5.2% | 6.0% | 8.1% | 10.3% | 12.4% |
| **Sharpe Ratio** | 1.6 | 1.5 | 1.1 | 0.9 | 0.8 |
| **Best 12 month Rolling return** | 43.1% | 44.1% | 46.3% | 48.2% | 50.2% |
| **Worst 12 month Rolling Return** | -9.7% | -13.3% | -21.1% | -28.0% | -33.9% |

**Value of $100 Invested**




Source: FactSet, Raymond James Ltd. As at September 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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**Patrick Choquette, CFP, CIM, CMT**
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**Patrick Carrington, CFA**
VP, Asset Management Services
Private Client Group

**Peter Matter**
VP, Product Compliance
Compliance

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