INVESTING

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Asset Allocation Strategy

Summer blues

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Market review

Equity markets were hit by the rise in global risks at the end of July that sent most indices tumbling. After coming within a hair's breadth of breaching 2000 points, the S&P 500 fell nearly 3% over the last week of the month, posting a total loss of 1.4% in July. Meanwhile, government bonds had a tough time playing their role of safe haven, with markets reassessing their expectations of future monetary policy following a slightly hawkish tone by the Federal Reserve. Ten-year treasury yields rose from a low of 2.44% to a high of 2.56% by the end of July, reversing the trend set in the first half of the month. Despite a pickup in inflation, gold prices fell from a high of US$1,339 per ounce to a low of US$1,282 over the period.

Asset allocation strategy

- **Equities:** Over the shorter-term, we recommend maintaining a prudent approach. Risks remain skewed to the downside and the probability of a further pullback cannot be excluded as seasonality becomes unfavourable to equities with the end of the summer approaching. Over the longer term, however, equities will continue to offer the best expected returns. We are maintaining our asset allocation stance over the 12 to 18-month horizon.
- **Fixed income:** With the Fed acknowledging that inflation is closer to its target and the job market continuing to improve, nominal yields are not appealing at current levels. If inflation begins to rear its ugly head, investors may want to hedge risks with real return bonds or gold.
- **Commodities:** Because of their very low price-to-book valuation, we continue to expect gold mining stocks to outperform the raw commodity.

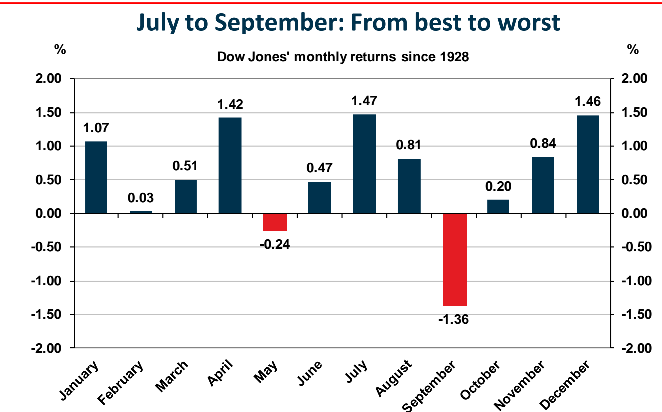
Table 1 Market total returns

Asset classes	July	YTD*	12-mths
Cash (3-month T-bills)	0.1%	0.5%	0.9%
Bonds (Dex Overall Universe)	**0.6%**	**5.5%**	**6.1%**
Dex Overall Federal	0.5%	4.1%	4.4%
Dex Overall Corporate	0.5%	5.3%	6.4%
Dex BBB	0.6%	6.7%	8.0%
World equity** (USD)	**-1.2%**	**5.2%**	**16.3%**
S&P/TSX	1.4%	14.5%	25.5%
S&P/TSX Small cap	-2.5%	15.0%	27.5%
S&P500 (USD)	-1.4%	5.7%	16.9%
Russell 2000 (USD)	-6.1%	-3.7%	7.3%
MSCI EAFE (USD)	-2.0%	3.1%	15.2%
MSCI EM (USD)	2.0%	8.5%	15.0%
Commodities (CRB index)	**-1.6%**	**7.0%**	**4.7%**
WTI oil (US$/barrel)	-7.0%	-0.6%	-4.9%
Gold (US$/ounce)	-2.3%	6.5%	-2.9%
Copper (US$/tonne)	1.3%	-3.3%	6.1%
Forex (JPM US Dollar index)	**1.6%**	**0.8%**	**1.3%**
USD per EUR	-2.3%	-2.9%	1.0%
JPY per USD	1.5%	-2.4%	4.9%
CAD per USD	2.2%	2.7%	5.8%

**MSCI AC * 2014/07/31

CHART OF THE MONTH

July to September: From best to worst



1 Source: Datastream

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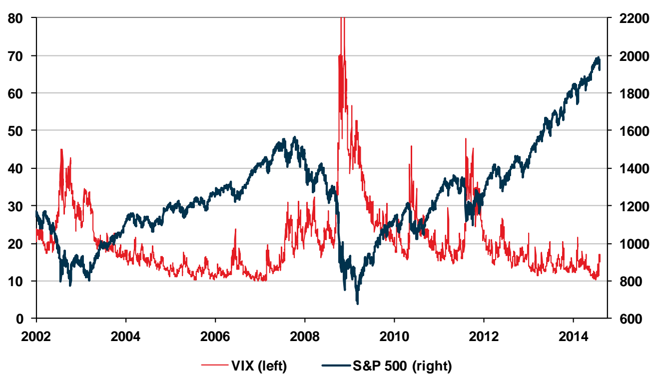
Risks or noise?

July was a month full of incidents. Take your pick: the Iraqi conflict, Israel launching a massive military offensive against Hamas in Gaza, the downing of a Malaysian Airlines' passenger plane by pro-Russians in the midst of the Ukraine conflict, the announcement of a set of tough new economic sanctions against Russia, the sovereign debt default by Argentina or the fall of *Banco Esperito Santo* in Portugal. And yet, the S&P 500 finished the month down just 1.5%. Take account of the rally in the US dollar and that loss turns into a gain of 0.7% for Canadian investors. The TSX did even better with a 1.4%-gain, propelled by the financial sector. Not too bad considering that bond yields went up 10 basis points in the second half of the month erasing all of the earlier gains.

Clearly, with all this action, volatility picked up from the abyssal level that was set at the beginning of the month (chart 2), but the VIX index nonetheless remains below its long term average of 20, suggesting that all these incidents were actually more noise than real market risks. Recall that the level of the VIX index is a measure of the market's expectations of stock volatility over a one-month period at an annualized rate. Therefore, at a current level of approximately 16, it indicates that the market expects the S&P 500 index could move, up or down, by roughly 1.3% over the next 30 days. In short, nothing out of the ordinary. And unless you think the conflicts in Israel and Ukraine will intensify further or that Argentina will default on more bonds, nothing we saw in July suggests that it is time to panic.

Still far from past episodes' peaks



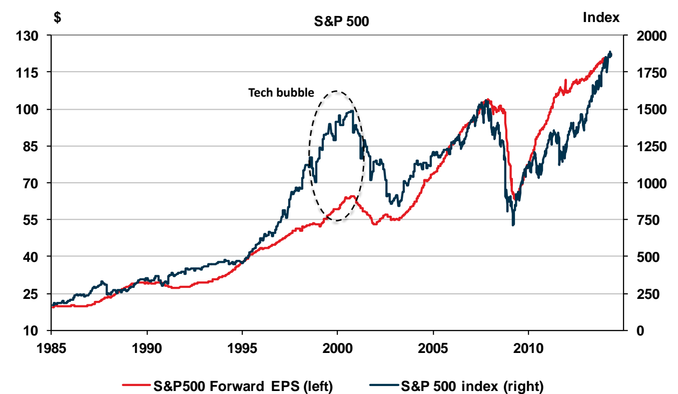
2 Source: Datastream

What to watch for

As we mentioned last month, the fact that most stock indices are flirting with record highs is, by itself, not a reason for an imminent pullback. Equity corrections need a catalyst that can either be market-led (overvaluation or overbought conditions) or cyclical (fading economic momentum). In any event, you can easily put together a list of indicators that will act as red flags or warning signs along the way. The ones we usually watch are:

1) *Price-to-earnings (PE) ratios.* While PEs are becoming pricey, they are not at a level that would necessarily lead to a pull-back. Remember that equity prices are a leading indicator for the economic cycle, so they tend to move ahead of earnings in the first phase of a market rally. In the second phase, as earnings growth accelerates (chart 3), equity markets continue to rise, but PE ratios stabilize.

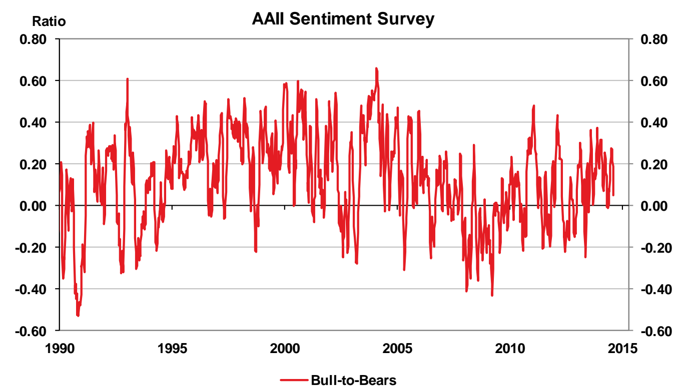
As long as earnings are growing



3 Source: Datastream

2) *Market sentiment.* You may have heard that equities are bound to correct because everyone is bullish these days. But according to a survey from the American Association of Individual Investors, the evidence on market sentiment is quite the opposite. Once adjusted for neutral positions, the difference between bulls and bears is currently sitting at just 10%. This compares with highs of almost 60% that were reached during the market peak of the 2000 (chart 4).

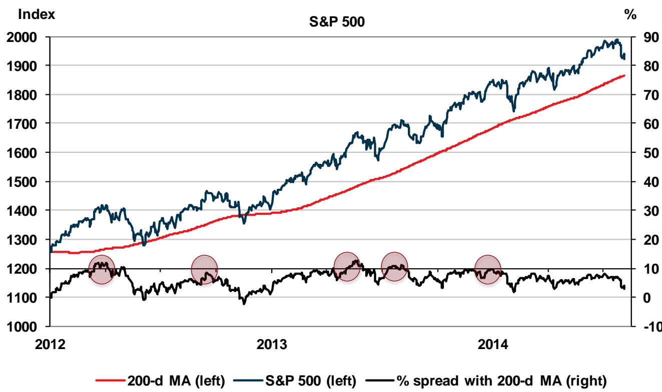
Not everyone is bullish



4 Source: Datastream

3) *Overbought conditions.* When the stock market fluctuates too far above or below its long-term trend, this is often a signal that equities are ripe for a correction. Watch for a 10% deviation from the 200-day moving average as a warning sign (chart 5).

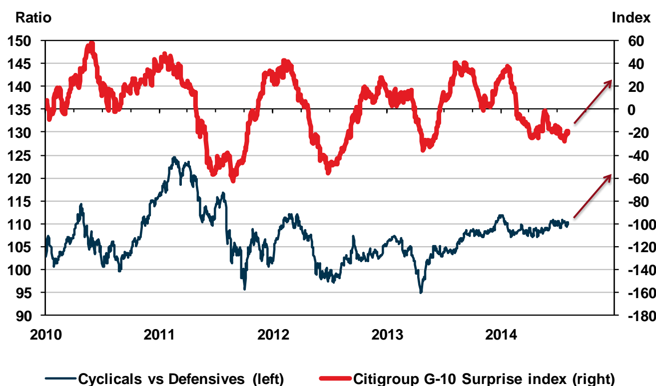
Markets are not currently overbought



5 Source: Datastream

4) *Defensive to cyclical sectors.* As the economic cycle matures, leadership moves from defensive sectors (staples, health care, utilities and telecom), to those that benefit the most from monetary policy easing (information technology, financials and discretionary spending), then on to cyclical sectors that are linked to inflation (industrials, materials and energy). Since the beginning of the year, utilities have been one of the best performing sectors, due to the fall in interest rates, partly offsetting the surge in IT share prices. However, the improving economy mixed with a rise in inflation means that cyclical sectors should continue to assume leadership (chart 6).

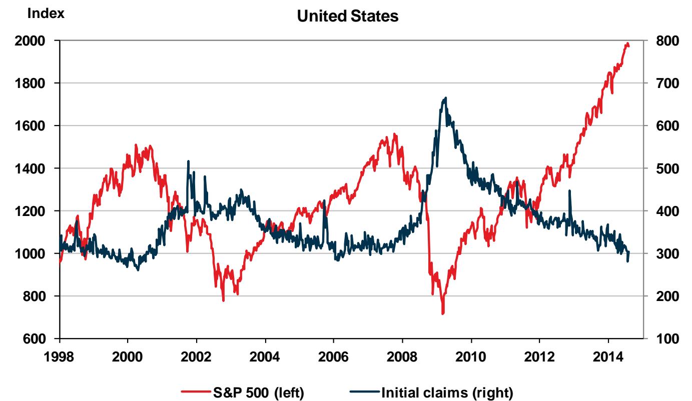
Stronger economy favorable to cyclicals



6 Source: Datastream

6) *Employment momentum.* The job sector is the foundation of any economy. While job creation and the unemployment rate cannot be overlooked, we like to watch the unemployment claims which give you a timely read of the economic cycle. As long as claims fall or stabilize around 300,000, the stock market usually continues to rise (chart 7).

Momentum in labor market should support equities



7 Source: Datastream

In conclusion, equities are vulnerable to a healthy pullback, but we don't think the situation points to a sharp correction. We recommend that you remain cautious over the short term and wait for a better entry point if you have already lowered your exposure to equities or if you have cash parked on the sidelines.

Table 2 Global Asset Allocation (Tactical vs Strategic)

Asset classes	3-month horizon: Weight — Min	Under	Equal	Over	Max	12 to 18-month horizon: Weight — Min	Under	Equal	Over	Max
Cash				■			■			
Bonds		■					■			
(Duration)			■				■			
Federal		■				■				
Investment grade			■				■			
High yield (USD)			■					■		
Non-traditional income				■					■	
World equities				■					■	
S&P/TSX				■				■		
S&P 500 (USD)				■					■	
Growth vs Value			■					■		
Large cap. vs Small cap.			■				■			
Defensives vs Cyclicals		■					■			
MSCI EAFE (USD)			■						■	
MSCI EM (USD)			■					■		
Alternative investments			■					■		
Commodities			■					■		
Energy				■					■	
Base metals				■					■	
Gold			■				■			
Hedge funds (USD)			■					■		
REITS		■					■			

Source: Consulting Investment Committee

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