



June 2017

Highlights

- Global equity markets continue to do well in 2017. Their year-to-date total return is 9.3% and, encouragingly, most of the main regions have continued to contribute in Q2. Equity benchmarks continue to be buoyed by an improving global economy.
- Leading economic indicators in the U.S. are trending up and earnings expectations improved but valuation of the stock market, unlike that of the overall MSCI AC, has been getting stretched.
- The S&P/TSX has continued to tread water in Q2. Though the economy remains sound, investor appetite for Energy and Bank stocks has waned.
- Our asset allocation remains largely unchanged this month as we maintain a tilt toward equities and away from bonds, with a higher-than-usual cash position. Though the current cyclical backdrop remains encouraging for equities, we remain wary of adding to our position at this time. In geographic allocation, we are reducing our overweight position in the U.S. to the benefit of Canada.

Stéfane Marion

stefane.marion@nbc.ca

Matthieu Arseneau

matthieu.arseneau@nbc.ca

Global equities remain strong

Global equity markets continue to do well in 2017. Their year-to-date total return is 9.3% and, encouragingly, most of the main regions have continued to contribute in Q2. Five months into the year, the clear winner is Emerging Asia with a 17.5% return, followed by Europe with 11.3% and the U.S. with 9.0% (table).

MSCI composite index: Price Performance (Total return)

	Month to date	Quarter to date	Year to date
MSCI AC World	1.9	3.3	9.3
MSCI World	1.8	3.0	8.7
MSCI USA	1.5	2.6	9.0
MSCI Canada	-1.0	-0.6	1.5
MSCI Europe	3.2	4.8	11.3
MSCI Pacific ex Jp	-0.8	0.9	8.9
MSCI Japan	2.3	3.4	3.4
MSCI EM	3.5	5.9	14.2
MSCI EM EMEA	0.7	4.7	4.7
MSCI EM Latin America	-0.1	0.7	8.5
MSCI EM Asia	4.8	7.1	17.5

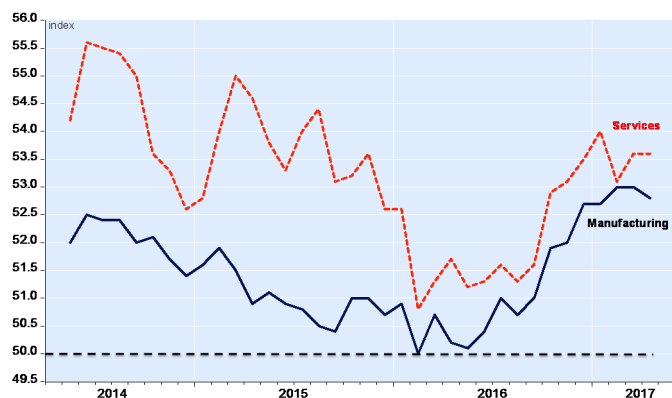
5/26/2017

NBF Economics and Strategy (data via Dastream)

Equity benchmarks continue to be buoyed by an improving global economy. World trade volume grew again in the first quarter of the year, pushing the average growth over the three quarters ending with Q1 to more than 5% annualized, the best nine-month run since 2011. And since trade grew faster than industrial output for a third consecutive quarter, the ratio of industrial production to trade volume (a proxy for inventories) fell to a four-year low. As the chart below shows, the global purchasing manager indexes remain firmly above 50, normally taken as the threshold of economic weakness.

World: Global economy remains firm

Markit PMIs for global composite

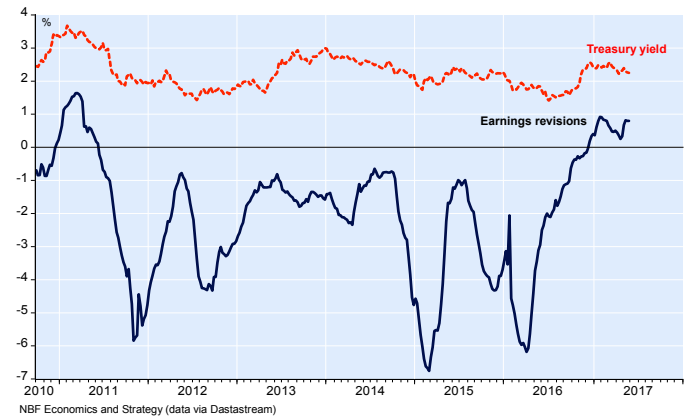


NBF Economics and Strategy (data via Dastream)

Stronger economic growth is of course good news for profits. Trailing earnings are rising for the first time in more than two years and the bottom-up consensus of equity analysts for 12-month-forward earnings growth is being revised upward for the first time since 2011. That was also the last time 10-year treasury yields reached 3% (chart).

World: Earnings revisions remain positive

3-month change in 12-month forward earnings growth for MSCI AC and yield on 10-year U.S. Treasury

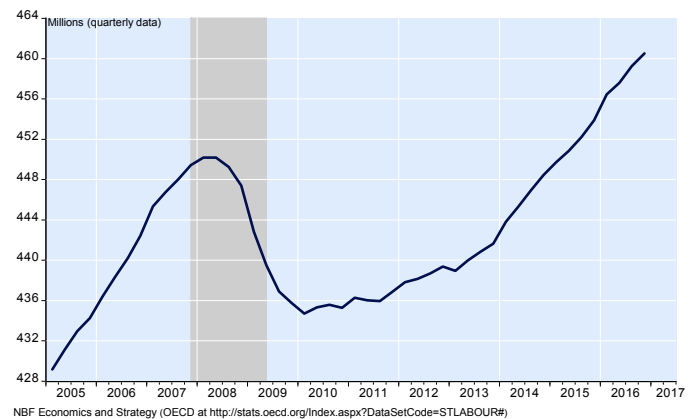


NBF Economics and Strategy (data via Dastream)

The big difference between 2011 and now, however, is that we have entered the expansion phase of the global economic cycle. Employment in the advanced economies has surged 6.6 million in the last year (chart). With business confidence hovering at pre-recession highs (chart), corporations should continue adding to headcounts.

World: This is finally starting to look like an expansion

Total employment in the advanced economies (G7 and rest of EU 28)



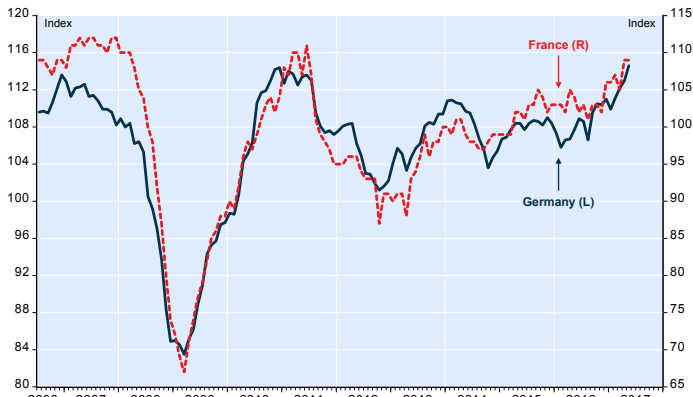
NBF Economics and Strategy (OECD at <http://stats.oecd.org/Index.aspx?DataSetCode=STLABOURR>)

This development is critical for credit growth and earnings growth in the months ahead, since P/E expansion is less likely at this stage of the economic cycle (which has only recently entered its mature phase). Since we find current earnings expectations reasonable, we are comfortable with current valuations (chart).

Monthly Equity Monitor

World: Business confidence surges in a number of regions

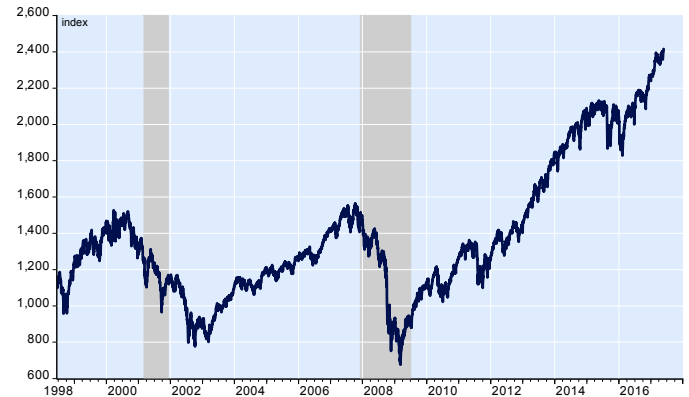
Germany's Ifo business climate index and France's manufacturing business confidence index



NBF Economics and Strategy (data from Bloomberg).

U.S.: A new record in May

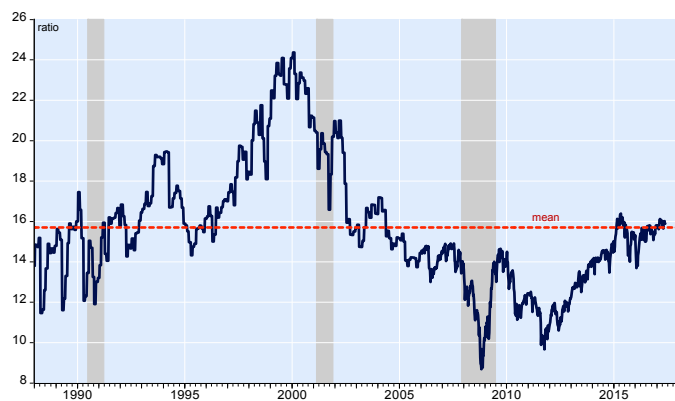
S&P 500



NBF Economics and Strategy (data via Datastream)

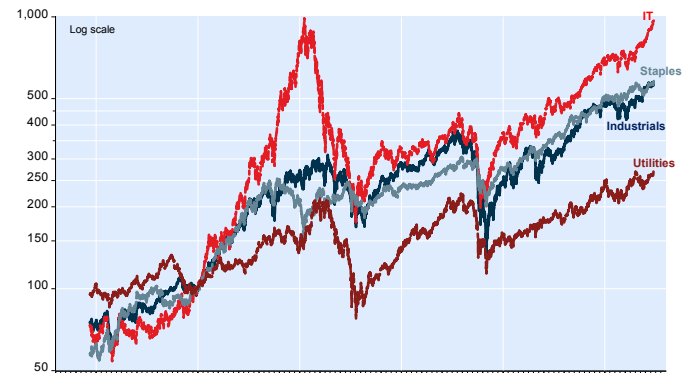
World: Perspective on valuations

Forward PEs



NBF Economics and Strategy (data via Datastream)

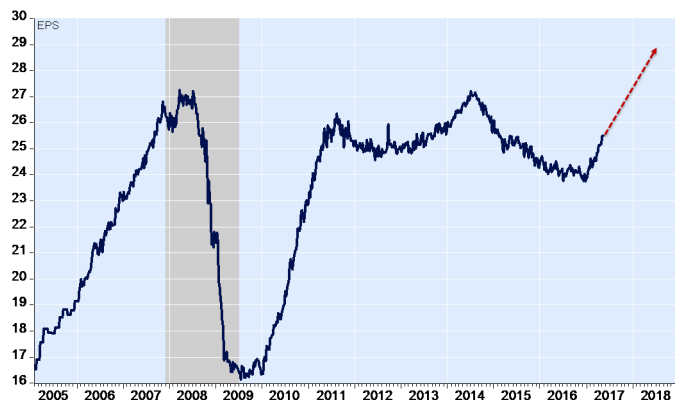
S&P 500: Perspective on sectors at new high



NBF Economics and Strategy (data via Datastream)

World: What's expected?

Trailing earnings MSCI AC

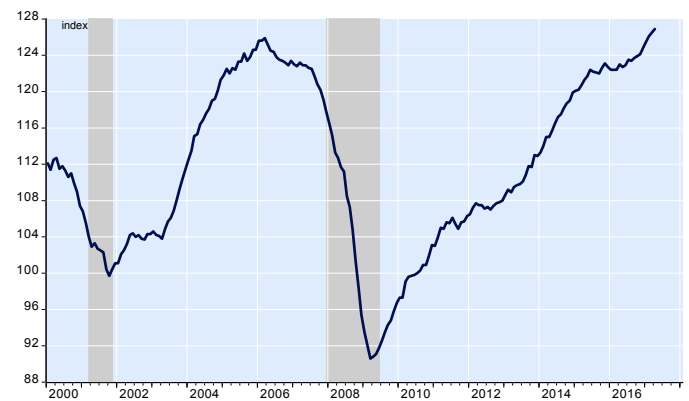


NBF Economics and Strategy (data via Datastream)

The U.S. leading economic indicator has been trending up in recent months, suggesting a 2%-plus growth rate in the second half of 2017 (chart). Consumption will be buoyed by the addition of more than 1.7 million full-time jobs in the first four months of the year, the best employment growth in more than 20 years.

U.S.: Outlook still encouraging

Leading economic indicator



NBF Economics and Strategy (data via Datastream)

U.S.: Market complacency?

The S&P 500 rose to a new all-time high in May, propelled by IT, Utilities, Consumer Staples and Industrials (chart). At this juncture, the outlook for economic growth and profits remains encouraging.

Monthly Equity Monitor

In parallel with these developments, equity analysts have become more upbeat on the U.S. market. Forward earnings are being revised upward for the first time since 2014 (chart).

U.S.: Revisions turn positive for the first time since 2014

3-month change in 12-month forward earnings growth for S&P 500



NBF Economics and Strategy (data via Datastream)

This is good news because the valuation of the U.S. market, unlike that of the overall MSCI AC, has been getting stretched. Its forward P/E of 17.7 is well above the historical average of 15.5 (table).

MSCI : Price to 12-month forward earnings

	5/26/2017	A year ago	5 year average	Average since 1988
MSCI AC World	15.9	15.4	14.3	15.7
MSCI World	16.6	16.0	14.8	16
MSCI USA	17.7	17.1	15.7	15.5
MSCI Canada	15.1	16.6	14.7	14.8
MSCI Europe	15.5	15.0	13.7	14
MSCI Pacific ex Jp	15.5	14.9	14.4	14
MSCI Japan	14.2	13.0	13.7	27.8
MSCI EM	12.3	11.4	11	13.1
MSCI EM EMEA	10.4	10.1	9.2	9.7
MSCI EM Latin America	12.7	13.1	12.7	11.1
MSCI EM Asia	12.7	11.4	11.1	14.1

NBF Economics and Strategy (data via Datastream)

What should we expect of U.S. equities in the months ahead? To answer this question it is important to gauge where we are in the economic cycle. We know the current expansion is getting long in the tooth – it has been eight years since the economic bottom. Does that necessarily make it mature? To weigh this question we define an expansion as “mature” when the unemployment rate falls below NAIRU (Non-Accelerating-Inflation Rate of Unemployment) – the rate at which inflation is neither rising nor falling, also known as the natural rate. It usually occurs when the economy has reached full capacity – when unemployed people are essentially either in transition

(frictional unemployment) or unsuited for employer needs (structural unemployment).¹

In cycles since 1950, an average of 32 months has elapsed from the time the unemployment rate has fallen below NAIRU to the onset of recession. The current expansion has only just reached maturity – the U.S. unemployment rate fell below NAIRU three months ago. We looked at the performance of U.S. equities by sector during the mature phase of expansions and found returns to be positive on average during the first year of the mature phase (table). Since forward P/E's are currently above the historical average for this point in the cycle, we expect returns to be in line with earnings growth (5% to 10%) and more uneven.

U.S. Equities: Performance during matured phase of expansion

Stock market after jobless rate fell below NAIRU, average of 4 episodes*

	3-month	6-month	12-month	Current episode
Total	7.1	11.8	20.7	5.7
Oil and gas	4.6	15.6	18.7	-8.1
Basic materials	7.9	16.5	21.4	-0.4
Gold	0.8	9.1	0.2	-1.4
Industrials	11.4	16.6	20.4	6.4
Cons. Goods	5.3	13.0	20.7	7.7
Consumer services	7.3	13.8	24.7	8.2
Healthcare	8.4	8.0	16.8	6.7
Telecom	4.7	6.1	22.9	-5.9
Utilities	3.2	2.2	12.3	9.3
Financials	8.6	12.9	23.8	2.1
Banks	7.1	12.6	20.1	-1.1
Insurance	7.7	10.4	24.5	3.5
Technology	7.8	15.0	23.6	13.6

* April 1978, November 1987, April 1997, December 2005
NBF Economics and Strategy (data via Datastream)

Canada: Banks get downgraded

The S&P/TSX has continued to tread water in Q2. Though the economy remains sound, investor appetite for Energy and Bank stocks has waned.

S&P/TSX composite index: Price Performance

	Month to date	Quarter to date	Year to date
S&P TSX	-1.1	-0.8	0.8
HEALTH CARE	10.3	2.2	-8.3
IT	2.6	6.3	13.6
INDUSTRIALS	2.4	4.9	10.0
UTILITIES	1.2	1.2	7.3
CONS. DISC.	0.3	4.2	10.9
REAL ESTATE	-0.6	0.9	4.2
TELECOM	-0.9	4.7	8.7
BANKS	-1.1	-4.6	-1.2
MATERIALS	-1.4	-1.8	3.9
CONS. STAP.	-1.6	3.6	5.9
FINANCIALS	-1.7	-3.6	-1.0
ENERGY	-2.9	-3.1	-9.1

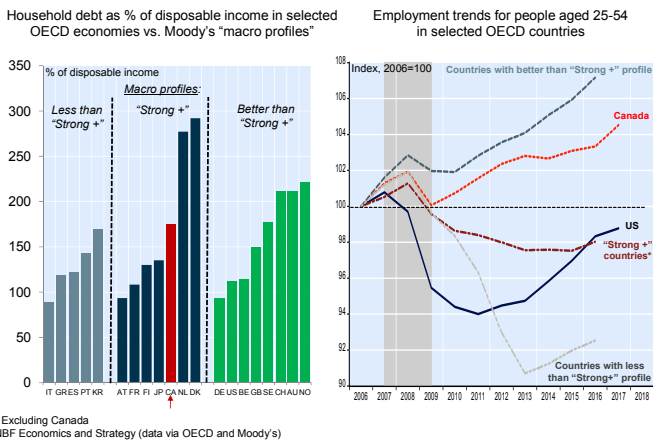
5/26/2017

NBF Economics and Strategy (data via Datastream)

¹ For details see our May 18 Special Report, “Where are we in the cycle?”

A major U.S. credit agency downgraded its ratings of Canada's largest banks in May. Moody's attributed its action to a change in its Canadian "macro profile" from "Very Strong –" to "Strong +" triggered by Canada's high household debt and continued credit expansion. Hmmm. As the chart below shows, Moody's assigns better macro profiles to a number of OECD countries with household indebtedness exceeding Canada's. What do those countries have in common? Strong employment growth for prime-aged workers (people aged 25-54), the group with the greatest propensity to use leverage. But is this not also the case in Canada? Job creation for the prime-aged populations of Canada's largest cities has been a key driver of its economy in recent years. Interestingly, among countries with rising prime-aged employment we are now one of the few to be tagged with a macro profile of only "Strong +." Prime-aged employment has declined in Denmark, the Netherlands, Japan, Finland and France. And if job creation for this group of workers had been as strong in the U.S. as in Canada in recent years, U.S. employment would be 5 million higher than it is now – a difference that explains much of the gap between the two countries' measures of household indebtedness.

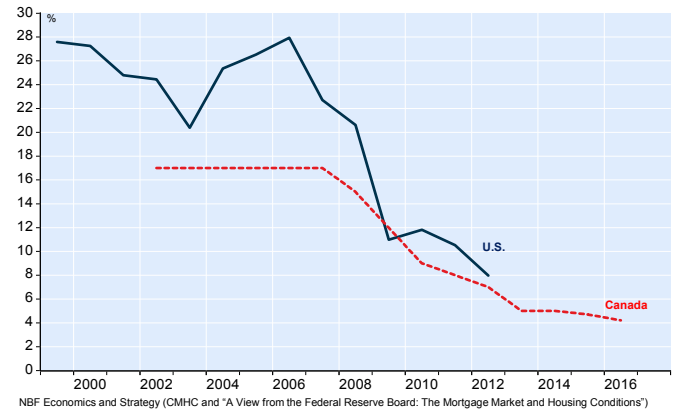
World: Why so moody on Canada?



In our view, the credit agency jumped the gun. Underwriting standards for mortgage debt in Canada have become an issue for many investors following the troubles of an alternative mortgage lender at a time when Ontario home price inflation is running ahead of fundamentals. Accelerating home price inflation should not come as a total surprise given that the Bank of Canada's monetary policy remains very accommodative at a time when the unemployment rate of Canada's most populous province is at a 17-year low. Fortunately, the Ontario government recently stepped in with a number of measures to cool its housing market. Meanwhile, we take solace from the continuing strictness of lending standards for first-time homeowners. As the chart below shows, the share of first-time Canadian homebuyers with a low credit score recently fell to a multi-year low of 4% – a far cry from the peak of 28% in the U.S. at the height of its housing bubble.

Canada: Lending standards are not U.S. circa 2006

Share of first-time homebuyers with low credit scores (FICO<620 and Beacon<660)

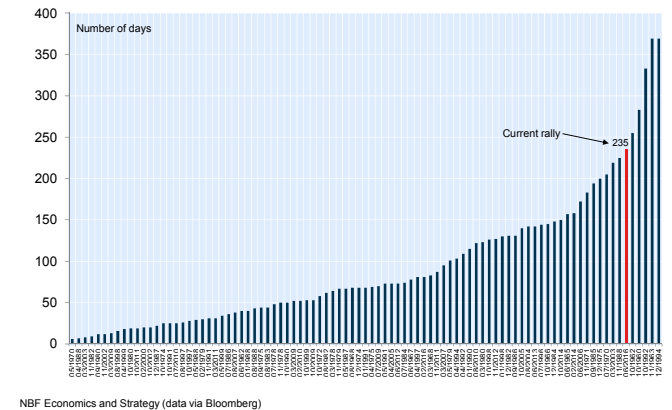


Asset allocation

Our asset allocation remains largely unchanged this month as we maintain a tilt toward equities and away from bonds, with a higher-than-usual cash position. Though the current cyclical backdrop remains encouraging for equities, we remain wary of adding to our position at this time. At 235 trading days, the S&P 500 is in the midst of the sixth longest streak since 1960 without experiencing a 5% pullback (chart).

S&P 500: Perspective on rally duration without a significant drawdown

Rallies without a > 5% correction since 1960

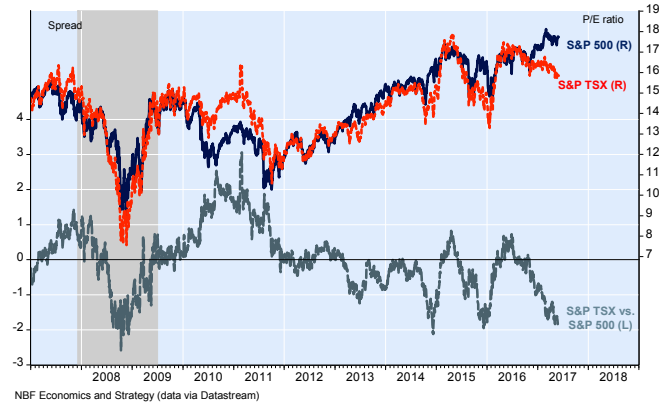


In geographic allocation, we are reducing our overweight position in the U.S. to the benefit of Canada. Our decision is based on our view that Canadian-dollar weakness is behind and that valuation spreads have turned more favourable for the S&P/TSX (chart).

Monthly Equity Monitor

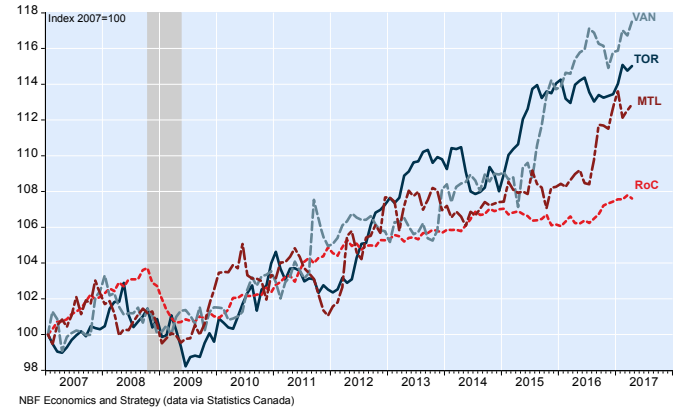
S&P TSX: Perspective on relative equity valuation

Price to 12 month forward earnings



Canada: perspective on job creation

Job creation in Vancouver, Toronto, Montreal and rest of Canada



Sector rotation

Our sector rotation remains unchanged this month with a bias toward Banks. At this writing, the S&P/TSX Banks are trading at 11.2 times forward earnings, below their historical average P/E (chart).

S&P/TSX: Banks PEs drop below historical average

Forward PEs for S&P/TSX Banks

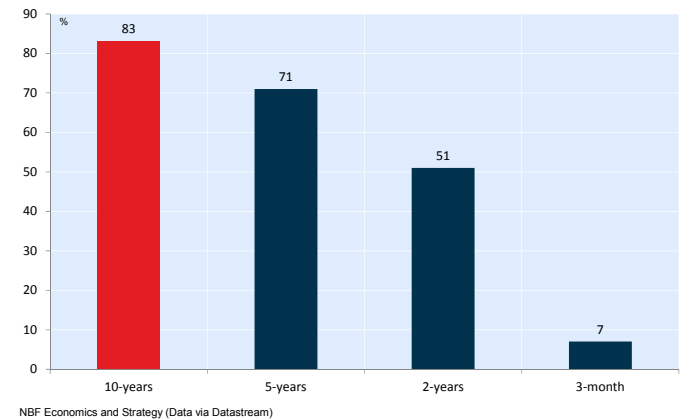


Though Ontario's recent decision to levy a tax on foreign buyers and vacant homes could cool the home-resale market and reduce the profitability of the main chartered banks, record employment in Canada's main metropolitan areas remains a plus for continued growth of consumer credit.

At the same time, we expect an offset from higher long-term interest rates as Canadian long rates rise in sympathy with those of the United States. As the chart below shows, the moving correlation between U.S. and Canadian market rates exceeds 70% for maturities of 5 to 10 years.

Canada: Market rates correlated to U.S.

Correlation of interest rates weekly variation over the last 10 years – Canada vs. U.S.



NBF Asset Allocation			
	Benchmark (%)	NBF Recommendation (%)	Change (pp)
Equities			
Canadian Equities	20	21	+3
U.S. Equities	20	20	-3
Foreign Equities (EAFE)	5	5	
Emerging markets	5	5	
Fixed Income	45	39	
Cash	5	10	
Total	100	100	

NBF Economics and Strategy

Monthly Equity Monitor

NBF Market Forecast			
Canada			
	<i>Actual</i>	<i>Q42017 (Est.)</i>	
<i>Index Level</i>	<i>Jun-02-17</i>	<i>Target</i>	
S&P/TSX	15,443	15,800	
Assumptions			<u>Q42017 (Est.)</u>
Level:	Earnings *	806	875
	Dividend	434	471
PE Trailing (implied)	19.1	18.1	
			<u>Q42017 (Est.)</u>
Treasury Bills (91 days)	0.52	0.63	
10-year Bond Yield	1.40	2.18	

* Before extraordinary items, source Thomson

NBF Economics and Strategy

NBF Market Forecast			
United States			
	<i>Actual</i>	<i>Q42017 (Est.)</i>	
<i>Index Level</i>	<i>Jun-02-17</i>	<i>Target</i>	
S&P 500	2,439	2,500	
Assumptions			<u>Q42017 (Est.)</u>
Level:	Earnings *	122	130
	Dividend	48	51
PE Trailing (implied)	19.9	19.2	
			<u>Q42017 (Est.)</u>
Treasury Bills (91 days)	0.96	1.33	
10-year Bond Yield	2.16	2.95	

* S&P operating earnings, bottom up.

Monthly Equity Monitor

NBF Fundamental Sector Rotation - June 2017

Name (Sector/Industry)	Recommendation	S&P/TSX weight
Energy	Underweight	20.6%
Energy Equipment & Services	Underweight	0.6%
Oil, Gas & Consumable Fuels	Underweight	20.0%
Materials	Market Weight	11.7%
Chemicals	Underweight	2.0%
Containers & Packaging	Market Weight	0.6%
Metals & Mining *	Market Weight	8.6%
Gold	Market Weight	6.0%
Paper & Forest Products	Overweight	0.5%
Industrials	Market Weight	9.6%
Capital Goods	Overweight	1.9%
Commercial & Professional Services	Underweight	1.7%
Transportation	Market Weight	6.0%
Consumer Discretionary	Underweight	5.5%
Automobiles & Components	Underweight	1.3%
Consumer Durables & Apparel	Overweight	0.5%
Consumer Services	Underweight	1.2%
Media	Market Weight	1.1%
Retailing	Underweight	1.3%
Consumer Staples	Underweight	4.0%
Food & Staples Retailing	Underweight	3.2%
Food, Beverage & Tobacco	Underweight	0.8%
Health Care	Market Weight	0.6%
Health Care Equipment & Services	Market Weight	0.2%
Pharmaceuticals, Biotechnology & Life Sciences	Market Weight	0.4%
Financials	Overweight	33.5%
Banks	Overweight	22.9%
Diversified Financials	Market Weight	4.2%
Insurance	Overweight	6.4%
Information Technology	Overweight	3.1%
Software & Services	Overweight	2.6%
Technology Hardware & Equipment	Market Weight	0.6%
Telecommunication Services	Market Weight	5.0%
Utilities	Market Weight	3.3%
Real Estate	Market Weight	3.0%

* Metals & Mining excluding the Gold Sub-Industry.

Monthly Equity Monitor

Economics and Strategy

Montreal Office

514-879-2529

Stéfane Marion

Chief Economist and Strategist

stefane.marion@nbc.ca

Paul-André Pinsonnault

Senior Fixed Income Economist

paulandre.pinsonnault@nbc.ca

Krishen Rangasamy

Senior Economist

krishen.rangasamy@nbc.ca

Marc Pinsonneault

Senior Economist

marc.pinsonneault@nbc.ca

Matthieu Arseneau

Senior Economist

matthieu.arseneau@nbc.ca

Angelo Katsoras

Geopolitical Analyst

angelo.katsoras@nbc.ca

Kyle Dahms

Economist

kyle.dahms@nbc.ca

Toronto Office

416-869-8598

Warren Lovely

MD, Public Sector Research and Strategy

warren.lovely@nbc.ca

General – National Bank Financial (NBF) is an indirect wholly owned subsidiary of National Bank of Canada. National Bank of Canada is a public company listed on Canadian stock exchanges.

The particulars contained herein were obtained from sources which we believe to be reliable but are not guaranteed by us and may be incomplete. The opinions expressed are based upon our analysis and interpretation of these particulars and are not to be construed as a solicitation or offer to buy or sell the securities mentioned herein.

Research Analysts – The Research Analyst(s) who prepare these reports certify that their respective report accurately reflects his or her personal opinion and that no part of his/her compensation was, is, or will be directly or indirectly related to the specific recommendations or views as to the securities or companies.

NBF compensates its Research Analysts from a variety of sources. The Research Department is a cost centre and is funded by the business activities of NBF including, Institutional Equity Sales and Trading, Retail Sales, the correspondent clearing business, and Corporate and Investment Banking. Since the revenues from these businesses vary, the funds for research compensation vary. No one business line has a greater influence than any other for Research Analyst compensation.

Canadian Residents – In respect of the distribution of this report in Canada, NBF accepts responsibility for its contents. To make further inquiry related to this report, Canadian residents should contact their NBF professional representative. To effect any transaction, Canadian residents should contact their NBF Investment advisor.

U.S. Residents – With respect to the distribution of this report in the United States, National Bank of Canada Financial Inc. (NBCFI) is regulated by the Financial Industry Regulatory Authority (FINRA) and a member of the Securities Investor Protection Corporation (SIPC). This report has been prepared in whole or in part by, research analysts employed by non-US affiliates of NBCFI that are not registered as broker/dealers in the US. These non-US research analysts are not registered as associated persons of NBCFI and are not licensed or qualified as research analysts with FINRA or any other US regulatory authority and, accordingly, may not be subject (among other things) to FINRA restrictions regarding communications by a research analyst with the subject company, public appearances by research analysts and trading securities held a research analyst account.

All of the views expressed in this research report accurately reflect the research analysts' personal views regarding any and all of the subject securities or issuers. No part of the analysts' compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this research report. The analyst responsible for the production of this report certifies that the views expressed herein reflect his or her accurate personal and technical judgment at the moment of publication. Because the views of analysts may differ, members of the National Bank Financial Group may have or may in the future issue reports that are inconsistent with this report, or that reach conclusions different from those in this report. To make further inquiry related to this report, United States residents should contact their NBCFI registered representative.

UK Residents – In respect of the distribution of this report to UK residents, National Bank Financial Inc. has approved the contents (including, where necessary, for the purposes of Section 21(1) of the Financial Services and Markets Act 2000). National Bank Financial Inc. and/or its parent and/or any companies within or affiliates of the National Bank of Canada group and/or any of their directors, officers and employees may have or may have had interests or long or short positions in, and may at any time make purchases and/or sales as principal or agent, or may act or may have acted as market maker in the relevant investments or related investments discussed in this report, or may act or have acted as investment and/or commercial banker with respect thereto. The value of investments can go down as well as up. Past performance will not necessarily be repeated in the future. The investments contained in this report are not available to retail customers. This report does not constitute or form part of any offer for sale or subscription of or solicitation of any offer to buy or subscribe for the securities described herein nor shall it or any part of it form the basis of or be relied on in connection with any contract or commitment whatsoever.

This information is only for distribution to Eligible Counterparties and Professional Clients in the United Kingdom within the meaning of the rules of the Financial Conduct Authority. National Bank Financial Inc. is authorised and regulated by the Financial Conduct Authority and has its registered office at 71 Fenchurch Street, London, EC3M 4HD.

National Bank Financial Inc. is not authorised by the Prudential Regulation Authority and the Financial Conduct Authority to accept deposits in the United Kingdom.

HK Residents – With respect to the distribution of this report in Hong Kong by NBC Financial Markets Asia Limited ("NBCFMA") which is licensed by the Securities and Futures Commission ("SFC") to conduct Type 1 (dealing in securities) regulated activity, the contents of this report are solely for informational purposes. It has not been approved by, reviewed by, verified by or filed with any regulator in Hong Kong. Nothing herein is a recommendation, advice, offer or solicitation to buy or sell a product or service, nor an official confirmation of any transaction. None of the products issuers, NBCFMA or its affiliates or other persons or entities named herein are obliged to notify you of changes to any information and none of the foregoing assume any loss suffered by you in reliance of such information.

The content of this report may contain information about investment products which are not authorized by SFC for offering to the public in Hong Kong and such information will only be available to, those persons who are Professional Investors (as defined in the Securities and Futures Ordinance of Hong Kong ("SFO")). If you are in any doubt as to your status you should consult a financial adviser or contact us. This material is not meant to be marketing materials and is not intended for public distribution. Please note that neither this material nor the product referred to is authorized for sale by SFC. Please refer to product prospectus for full details.

There may be conflicts of interest relating to NBCFMA or its affiliates' businesses. These activities and interests include potential multiple advisory, transactional and financial and other interests in securities and instruments that may be purchased or sold by NBCFMA or its affiliates, or in other investment vehicles which are managed by NBCFMA or its affiliates that may purchase or sell such securities and instruments.

No other entity within the National Bank of Canada group, including NBF, is licensed or registered with the SFC. Accordingly, such entities and their employees are not permitted and do not intend to: (i) carry on a business in any regulated activity in Hong Kong; (ii) hold themselves out as carrying on a business in any regulated activity in Hong Kong; or (iii) actively market their services to the Hong Kong public.

Copyright – This report may not be reproduced in whole or in part, or further distributed or published or referred to in any manner whatsoever, nor may the information, opinions or conclusions contained in it be referred to without in each case the prior express written consent of National Bank Financial.