Monthly Equity Monitor

Economics and Strategy

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.

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Monthly Equity Monitor

NATIONAL BANK OF CANADA FINANCIAL MARKETS

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)

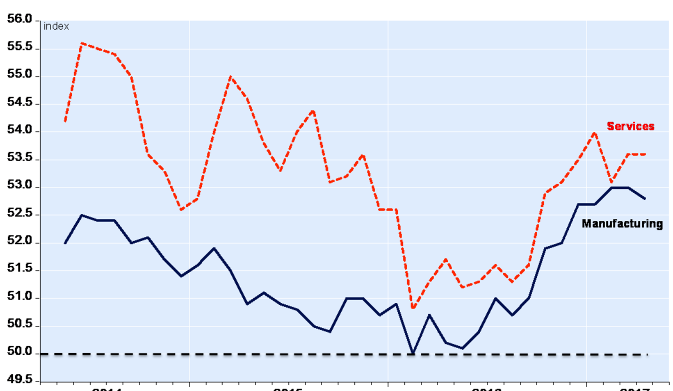
	Month to date	Quarter to date	Year to date
MSCI AC World	1.9	3.3	9.3
MSCI World	1.8	3.0	8.7
MSCI USA	1.5	2.6	9.0
MSCI Canada	-1.0	-0.6	1.5
MSCI Europe	3.2	4.8	11.3
MSCI Pacific ex Jp	-0.8	0.9	8.9
MSCI Japan	2.3	3.4	3.4
MSCI EM	3.5	5.9	14.2
MSCI EM EMEA	0.7	4.7	4.7
MSCI EM Latin America	-0.1	0.7	8.5
MSCI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

5/26/2017

NBF Economics and Strategy (data via Datastream)

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.

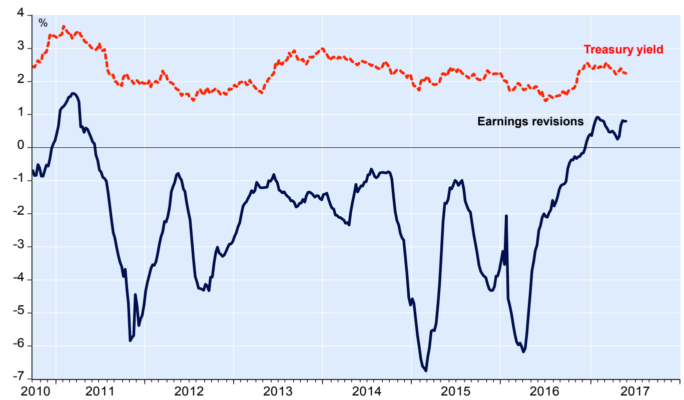
World: Global economy remains firm
Markit PMIs for global composite



NBF Economics and Strategy (data via Datastream)

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).

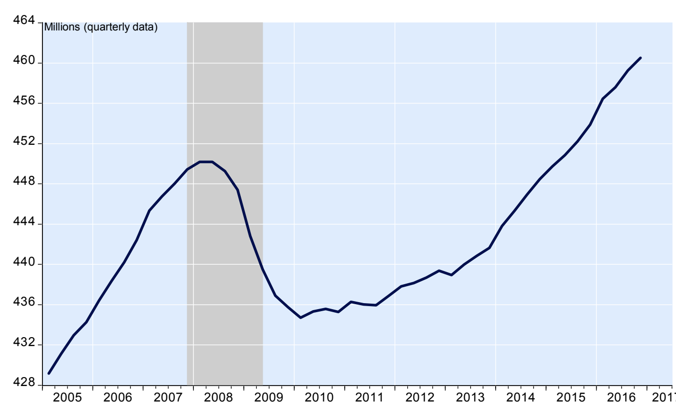
World: Earnings revisions remain positive
3-month change in 12-month forward earnings growth for MSCI AC and yield on 10-year U.S. Treasury



NBF Economics and Strategy (data via Dastastream)

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)



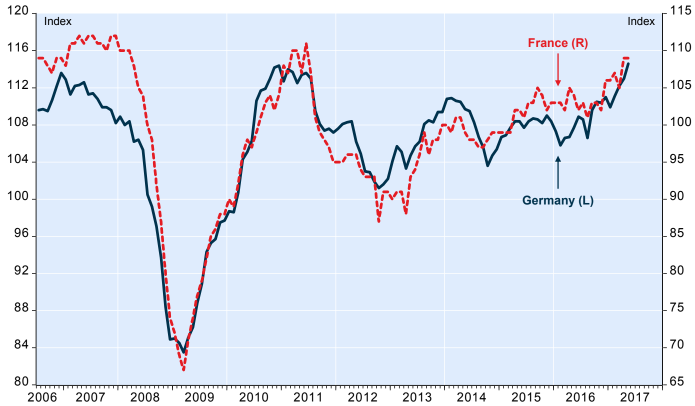
NBF Economics and Strategy (OECD at http://stats.oecd.org/Index.aspx?DataSetCode=STLABOUR#)

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

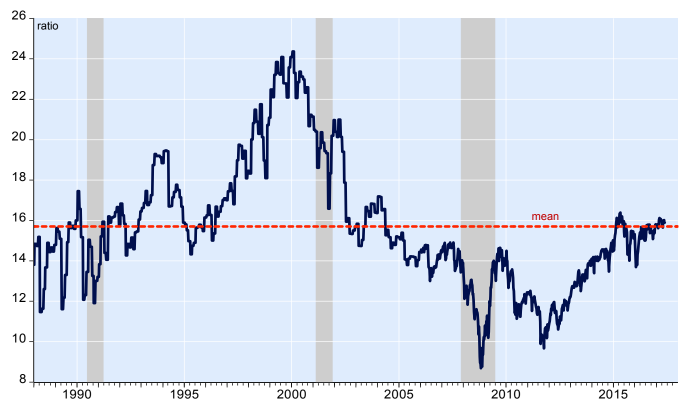
NATIONAL BANK OF CANADA FINANCIAL MARKETS

World: Business confidence surges in a number of regions
Germany's Ifo business climate index and France's manufacturing business confidence index



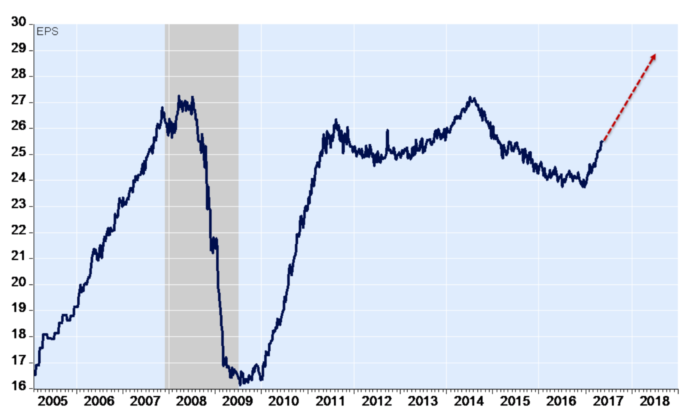
NBF Economics and Strategy (data from Bloomberg).

World: Perspective on valuations
Forward PEs



NBF Economics and Strategy (data via Dastastream)

World: What's expected?
Trailing earnings MSCI AC

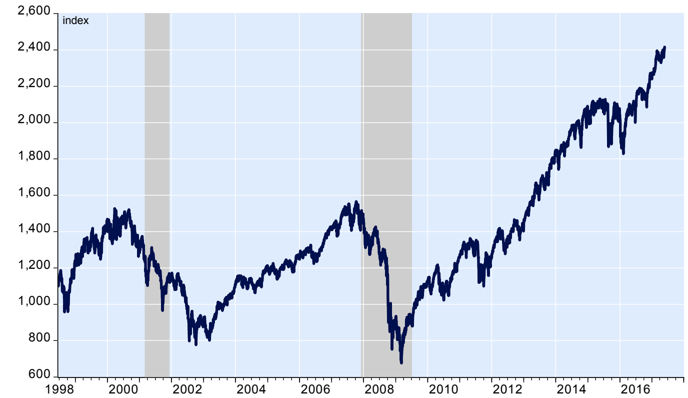


NBF Economics and Strategy (data via Dastastream)

U.S.: Market complacency?

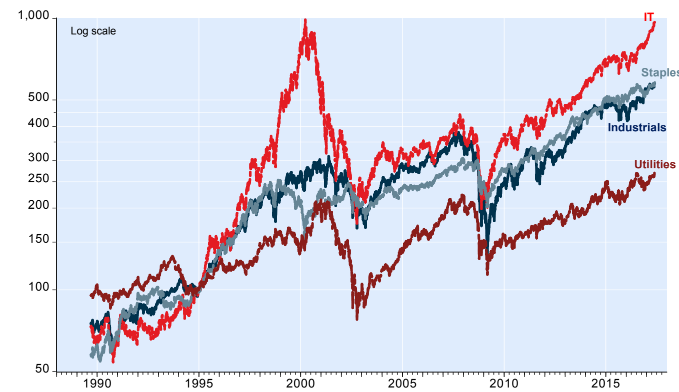
The S&P 500 rose to a new all-time high in May, propelled by IT, Utilities, Consumer Staples and Industrials (chart). At this juncture, the outlook for economic growth and profits remains encouraging.

U.S.: A new record in May
S&P 500



NBF Economics and Strategy (data via Dastastream)

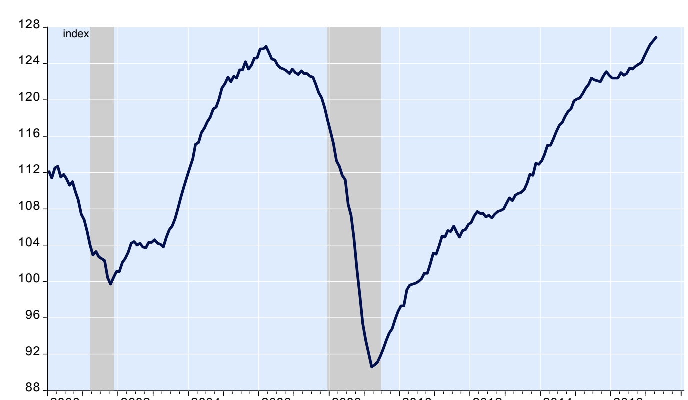
S&P 500: Perspective on sectors at new high



NBF Economics and Strategy (data via Dastastream)

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.

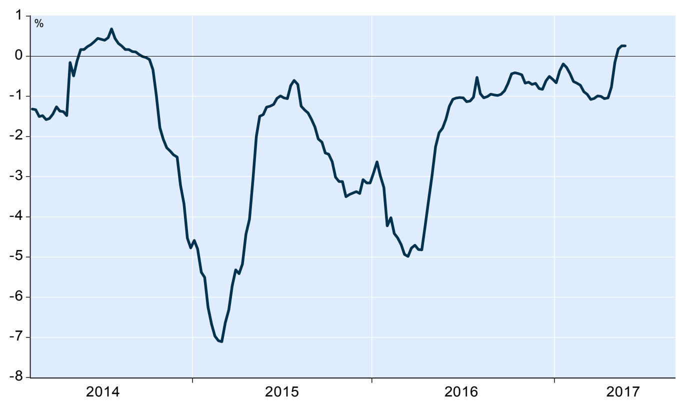
U.S.: Outlook still encouraging
Leading economic indicator



NBF Economics and Strategy (data via Dastastream)

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/Es 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 epidose
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

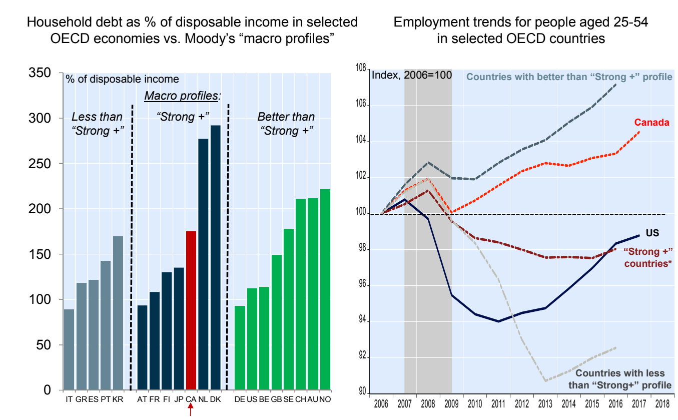
	Month to date	Quarter to date	Year to date
S&P TSX	-1.1	-0.8	0.8
HEALTH CARE	10.3	2.2	-8.3
IT	2.6	6.3	13.6
INDUSTRIALS	2.4	4.9	10.0
UTILITIES	1.2	1.2	7.3
CONS. DISC.	0.3	4.2	10.9
REAL ESTATE	-0.6	0.9	4.2
TELECOM	-0.9	4.7	8.7
BANKS	-1.1	-4.6	-1.2
MATERIALS	-1.4	-1.8	3.9
CONS. STAP.	-1.6	3.6	5.9
FINANCIALS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

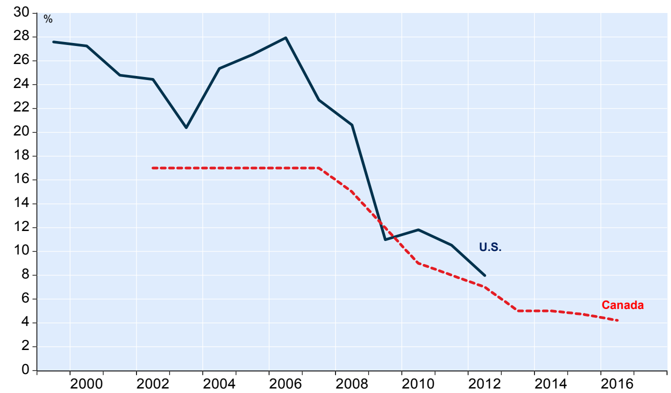


* Excluding Canada
NBF Economics and Strategy (data via OECD and Moody's)

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)



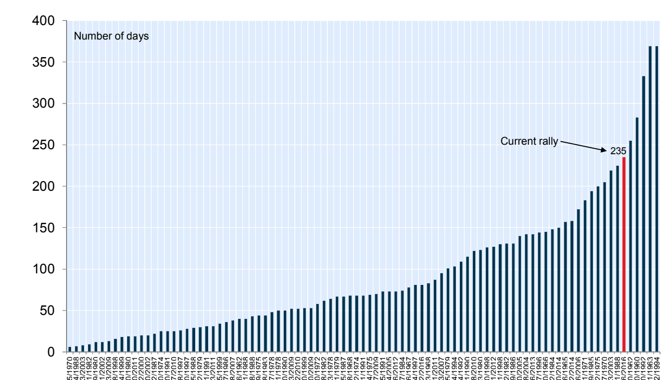
NBF Economics and Strategy (CMHC and "A View from the Federal Reserve Board: The Mortgage Market and Housing Conditions")

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

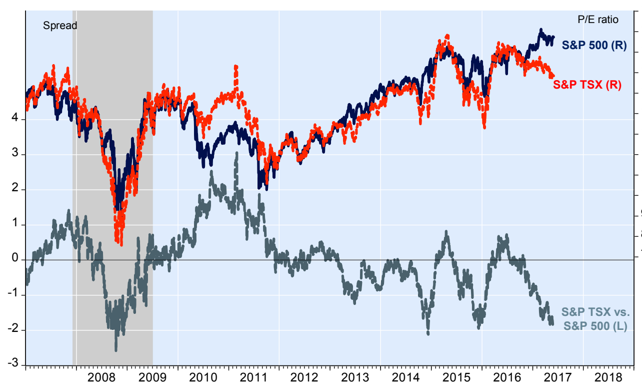


NBF Economics and Strategy (data via Bloomberg)

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).

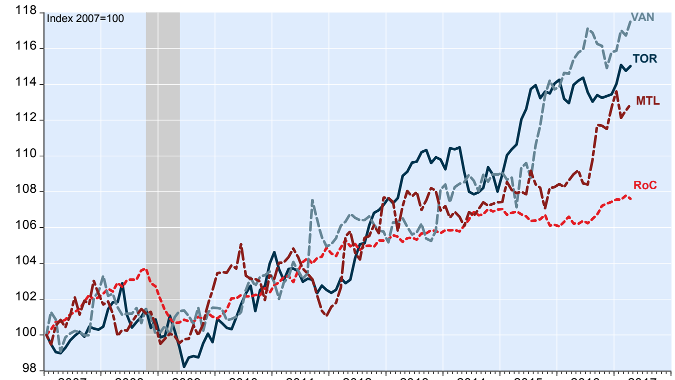
Monthly Equity Monitor

S&P TSX: Perspective on relative equity valuation
Price to 12 month forward earnings



NBF Economics and Strategy (data via Datastream)

Canada: perspective on job creation
Job creation in Vancouver, Toronto, Montreal and rest of Canada

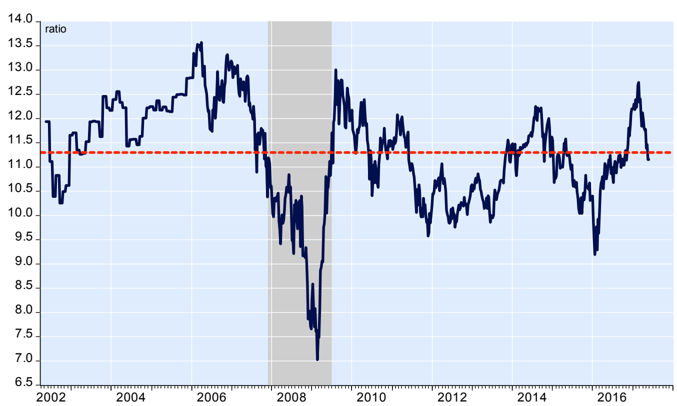


NBF Economics and Strategy (data via Statistics Canada)

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

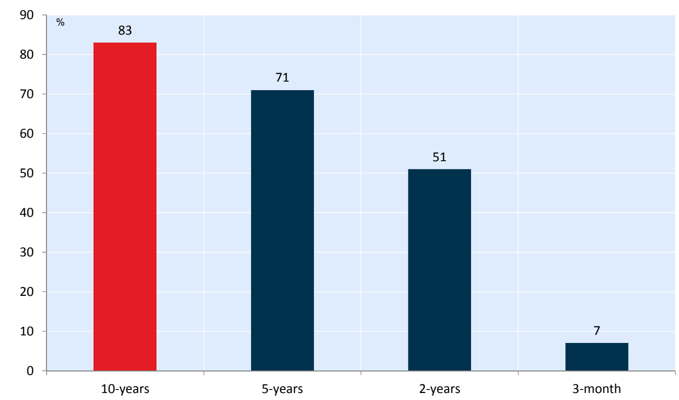


NBF Economics and Strategy (data via Dastastream)

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 Economics and Strategy (Data via Datastream)

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	

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NBF Market Forecast *Canada*			
		Actual	***Q42017 (Est.)***
Index Level		**Jun-02-17**	***Target***
S&P/TSX		15,443	15,800
Assumptions			Q42017 (Est.)
Level:	Earnings *	806	875
	Dividend	434	471
PE Trailing (implied)		19.1	18.1
			Q42017 (Est.)
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*			
		Actual	***Q42017 (Est.)***
Index Level		**Jun-02-17**	***Target***
S&P 500		2,439	2,500
Assumptions			Q42017 (Est.)
Level:	Earnings *	122	130
	Dividend	48	51
PE Trailing (implied)		19.9	19.2
			Q42017 (Est.)
Treasury Bills (91 days)		0.96	1.33
10-year Bond Yield		2.16	2.95

** S&P operating earnings, bottom up.*

NATIONAL BANK OF CANADA FINANCIAL MARKETS

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.*

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Economics and Strategy

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