NATIONAL BANK OF CANADA
FINANCIAL MARKETS

Monthly Equity Monitor

Economics and Strategy

December 2017

Highlights

- The MSCI AC is on track to return more than 15% this year, the best showing in four years. Importantly, the equity rally remains fuelled by better-than-expected profits. As long as financial conditions stay accommodative, a large stock market correction is unlikely.
- As the U.S. economy enters its 121st month since the pre-recession peak and the S&P 500 reaches new highs, leading indicators are still flashing green. The current bottom-up consensus of equity analysts sees earnings growth of 11.0% over the year ahead. We think this target is reasonable and could even be bettered if Washington delivers on its proposed tax cuts
- At this writing the S&P/TSX remains slightly below its all-time high of 16,132, reached on November 7, 2017. All sectors but Energy are up so far in Q4. Future S&P/TSX earnings will depend on the performance of the global economy and on commodity prices. If the global economy is as resilient as we think it is, the bottom-up analyst consensus will need to reshuffle its commodity price deck for 2018.
- Though we remain upbeat on the outlook for the Canadian economy in 2018, we recognize two main uncertainties: consumer debt and NAFTA.
- Our asset allocation is unchanged this month. We continue to prefer stocks over bonds. Though monetary policy is set to normalize further in many countries in 2018, we do not expect it to become restrictive any time soon.

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World: Profits are surging

Global equities continue to do very well. The MSCI All Country index is up 3.3% so far in Q4, with positive contributions from all major regions of the world (table). The global benchmark is on track to return more than 15% this year, the best showing in four years.

MSCI composite index: Price Performance

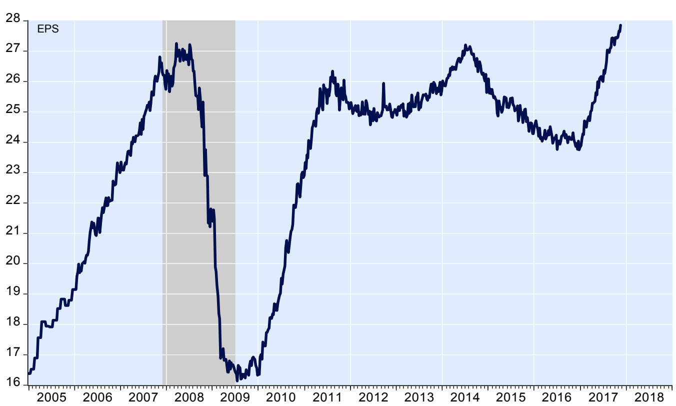
	Month to date	Quarter to date	Year to date
MSCI AC World	0.7	3.3	15.6
MSCI World	0.5	3.0	14.1
MSCI USA	1.1	3.3	16.5
MSCI Canada	0.6	3.3	5.5
MSCI Europe	-1.6	0.4	9.4
MSCI Pacific ex Jp	2.5	5.4	13.9
MSCI Japan	0.9	6.5	15.5
MSCI EM	2.1	6.0	28.6
MSCI EM EMEA	2.3	6.1	11.1
MSCI EM Latin America	-1.4	-1.8	15.7
MSCI EM Asia	2.6	7.3	35.2

11/24/2017

NBF Economics and Strategy (data via Datastream)

Importantly, the equity rally remains fuelled by better-than-expected profits. As the chart below shows, MSCI AC index earnings have finally topped the pre-recession peak.

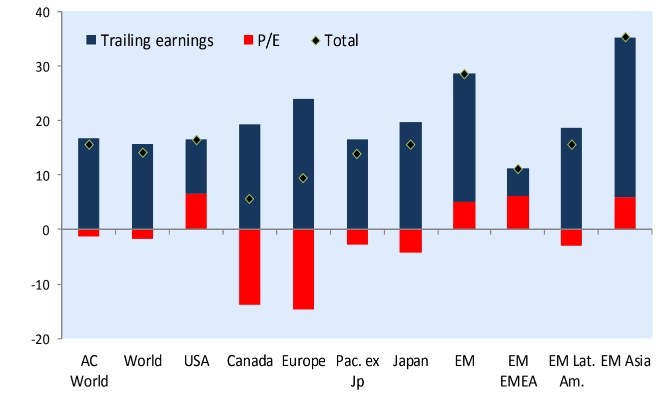
World: Profits are at a record high
Trailing profits for the MSCI AC



NBF Economics and Strategy (data via Datastream)

Interestingly, the surge in earnings is broad-based. As the chart below shows, profits, not P/E expansion, have been the growth drivers in most markets in 2017.

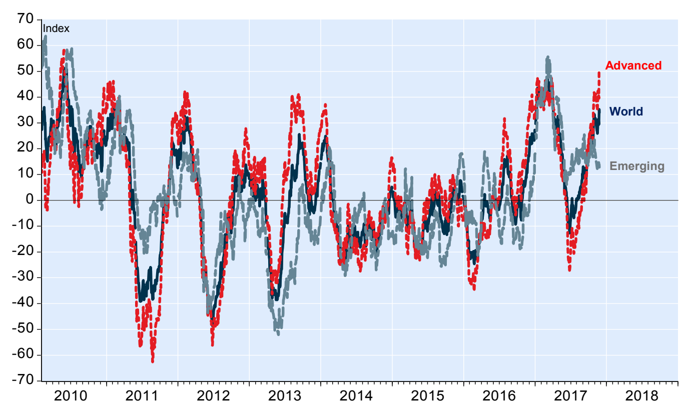
World: Breakdown of equity-market return (year-to-date)



NBF Economics and Strategy (data via Datastream)

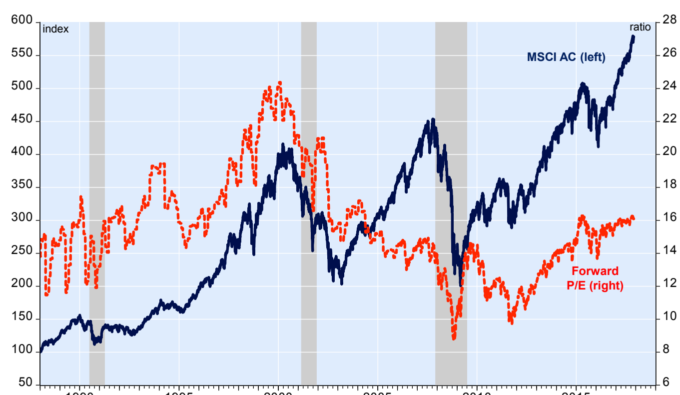
We expect this state of affairs to last as long as economic indicators keep beating expectations. Globally, as the chart below shows, economic surprises are currently the most upbeat in more than a year. In the advanced world they are the best in seven years. So 2018 will begin on a strong footing. As long as financial conditions stay accommodative, a large stock market correction is unlikely.

World: Economy continues to surprise on the upside
Citi economic surprise index



NBF Economics and Strategy (data via Bloomberg)

Global equities: Record level with a stable P/E
MSCI AC and its 12-month-forward P/E



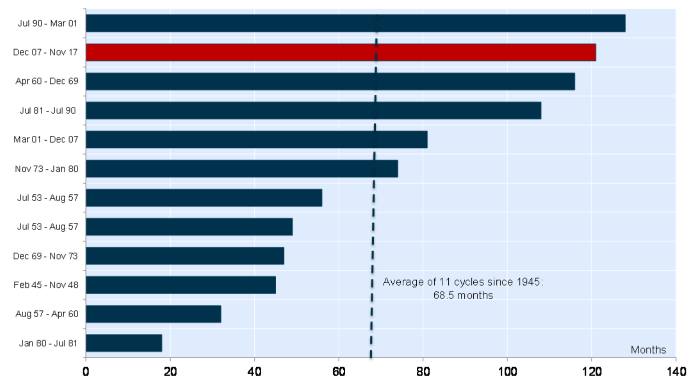
NBF Economics and Strategy (data via Datastream)

Monthly Equity Monitor

U.S.: Leading indicator flashing green

As the U.S. economy enters its 121st month since the pre-recession peak and the S&P 500 reaches new highs, leading indicators are still flashing green.

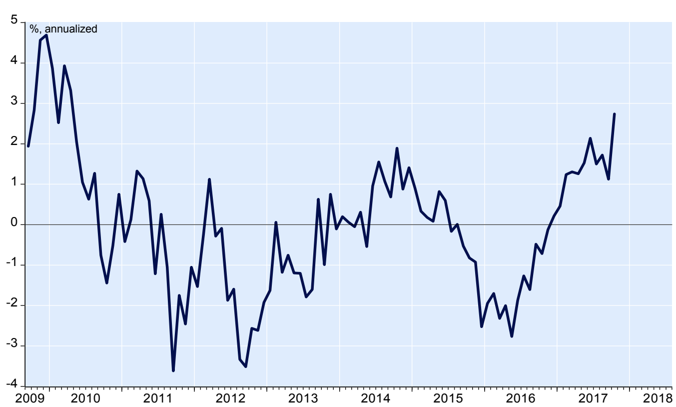
U.S.: The second longest business cycle on record
Duration of economic cycles since 1945 (peak to peak)



NBF Economics and Strategy (http://www.nber.org/cycles.html)

The October rise of the leading economic indicator (LEI) was the largest in four years. We are especially encouraged by the strength of the nonfinancial LEI components: as the chart below shows, it is the real economy, not financial indicators, that is driving the LEI. This bodes well for our scenario of continuing above-potential growth in coming quarters.

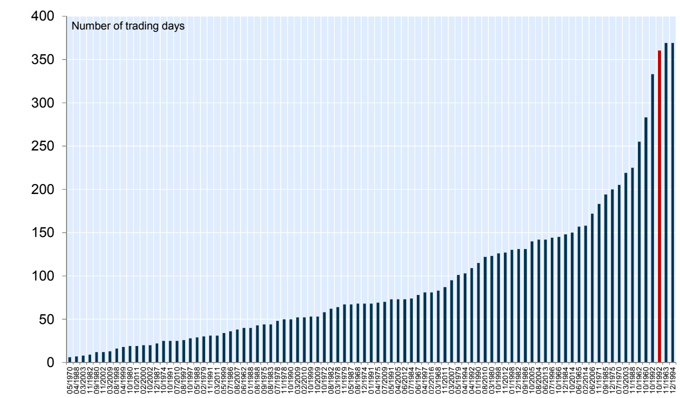
U.S.: Outlook remains positive
Six-month change in the leading economic index (non-financial components)



NBF Economics and Strategy (Conference Board data via Datastream)

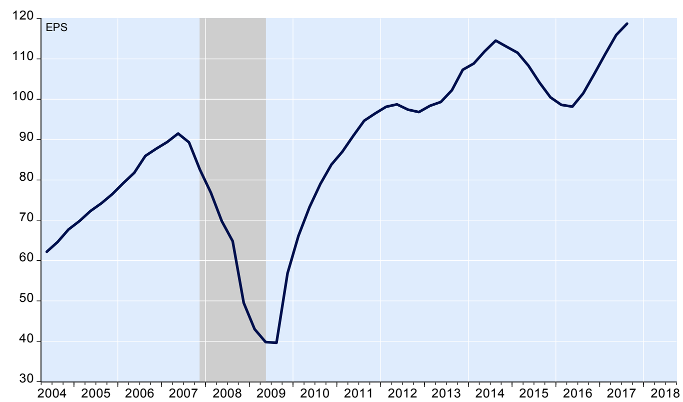
Q3 earnings announcements have helped extend the S&P 500 rally to 355 days without a correction of 5% or more, the third-longest such run in modern U.S. history. Of the 489 companies reporting at this writing, Thomson Reuters tallies 72% beating expectations. Year-over-year earnings growth is on track to exceed 8%, much better than the 4.2% anticipated on the eve of Q3 reporting. After a two-year hiatus, profits are posting their strongest comeback since 2010. The current bottom-up consensus of equity analysts sees earnings growth of 11.0% over the year ahead (table). We think this target is reasonable and could even be bettered if Washington delivers on its proposed tax cuts.

S&P 500: Third longest rally ever
Rallies without a > 5% correction since 1960



NBF Economics and Strategy (data via Bloomberg)

U.S.: Earnings have recovered
Operating earnings per share (EPS)



NBF Economics and Strategy (data via Standard & Poors at http://us.spindices.com/indices/equity/sp-500)

S&P 500 composite index: EPS Performance

	2016	2017	2018	2019	12 months forward
S&P 500	1.7	10.9	11.3	10.1	11.0
ENERGY	-80.1	353.6	36.4	22.8	42.7
MATERIALS	-7.4	13.2	18.5	10.5	20.3
INDUSTRIALS	2.2	3.3	9.4	12.1	8.8
CONS. DISC.	12.4	5.8	9.2	11.4	8.8
CONS. STAP.	4.2	5.3	7.7	7.8	7.5
HEALTH CARE	8.9	7.3	6.8	9.6	6.8
FINANCIALS	0.9	8.7	15.5	9.8	15.0
IT	5.8	16.7	13.6	9.1	12.8
TELECOM	0.2	-1.8	-0.6	1.9	-0.7
UTILITIES	5.9	1.7	4.7	5.2	4.5
REAL ESTATE	23.4	-15.1	-10.1	10.6	-10.6

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NBF Economics and Strategy (data via Datastream)

Canada: Gains more broad-based

At this writing the S&P/TSX remains slightly below its all-time high of 16,132, reached on November 7, 2017. All sectors but Energy are up so far in Q4. Year to date the index has returned 5.4% despite a 10.9% decline of energy stocks (table).

S&P/TSX composite index: Price Performance

	Month to date	Quarter to date	Year to date
S&P TSX	0.5	3.0	5.4
HEALTH CARE	17.7	17.4	6.4
TELECOM	3.6	6.6	13.6
CONS. STAP.	2.9	5.2	5.7
IT	2.1	5.0	18.1
REAL ESTATE	2.0	5.2	6.3
MATERIALS	0.9	2.5	4.1
CONS. DISC.	0.9	4.1	20.4
BANKS	0.6	5.0	9.8
FINANCIALS	0.5	4.5	9.2
UTILITIES	0.0	3.1	7.8
ENERGY	-0.7	-1.1	-10.9
INDUSTRIALS	-1.7	1.6	15.2

11/24/2017
NBF Economics and Strategy (data via Datastream)

Future S&P/TSX earnings will depend on the performance of the global economy and on commodity prices. At this writing, we note that copper, crude oil and gold prices are currently above those assumed by analysts over the next year (table). If the global economy is as resilient as we think it is, the bottom-up analyst consensus will need to reshuffle its commodity price deck for 2018. This prospect implies upward revision of forward earnings.

Commodity prices expectations

Analyst Assumptions

	Copper	Gold	Crude Oil	Natural Gas
Current Price	7002	1289	59	2.81
Analyst assumptions				
Q+2	6375	1250	52	3.10
Q+4	6550	1250	55	3.20
Growth (Q_t/Q_0)				
Q+2	-9.0%	-3.0%	-11.6%	10.2%
Q+4	-6.5%	-3.0%	-7.4%	13.8%

Current Forward Prices

	Copper	Gold	Crude Oil	Natural Gas
Current Price	7002	1289	59	2.81
Forward prices				
Q+2	7032	1299	58	2.85
Q+4	7058	1313	56	3.08
Growth (Q_t/Q_0)				
Q+2	0.4%	0.8%	-2.0%	1.3%
Q+4	0.8%	1.8%	-5.5%	9.5%

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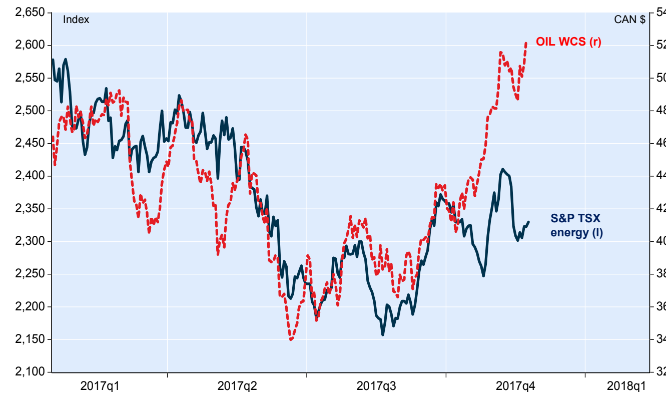
NBF Economics and Strategy (data via Datastream)

S&P TSX: Perspective on energy sector and oil price
S&P TSX Energy and WCS oil price



NBF Economics and Strategy (data via Datastream)

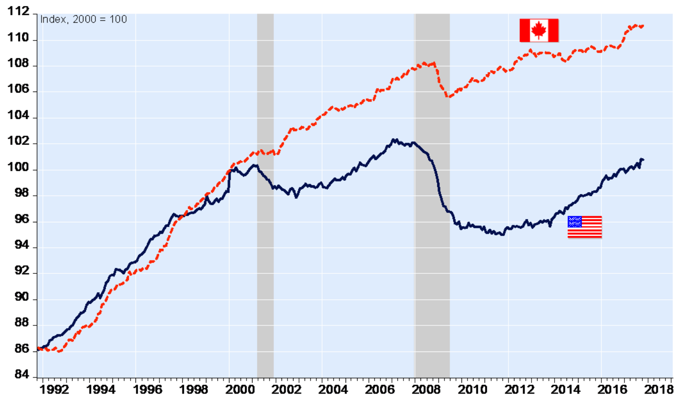
S&P/TSX composite index: EPS Performance

	2016	2017	2018	2019	12 months forward
S&P TSX	0.9	25.9	9.5	11.6	10.5
ENERGY	85.3	304.8	7.9	24.7	14.4
MATERIALS	37.4	52.1	14.8	16.2	16.9
INDUSTRIALS	-11.2	15.4	13.7	12.1	13.8
CONS. DISC.	1.2	15.3	13.9	11.5	13.8
CONS. STAP.	9.0	14.0	12.7	10.4	13.3
HEALTH CARE	-54.8	-31.5	-1.4	18.0	-5.6
FINANCIALS	-1.1	12.8	7.6	7.8	7.8
BANKS	4.1	9.9	5.4	7.2	5.5
IT	18.7	9.4	18.0	13.5	15.7
TELECOM	4.7	3.5	6.8	6.6	6.5
UTILITIES	28.5	-3.6	27.7	6.2	25.4
REAL ESTATE	-10.9	21.7	-6.8	7.8	-4.5

11/24/2017
NBF Economics and Strategy (data via Datastream)

Though we remain upbeat on the outlook for the Canadian economy in 2018, we recognize two main uncertainties: consumer debt and NAFTA. In November the OECD followed the IMF in warning about Canada's high household debt relative to the U.S. As we pointed out in last month's Equity Monitor, the divergence of Canada's debt-to-disposable-income ratio from that of the U.S. reflects the strength of its demographic fundamentals. As the chart below shows, Canada diverges massively from the U.S. in its employment of people aged 25-54, traditionally more likely to use leverage. In the U.S., the number of workers employed in this age group is no higher than it was 17 years ago, while in Canada it has grown 10%. So as long as employment growth remains robust for this all-important age cohort and monetary policy remains accommodative, we do not foresee a collapse of real estate prices hurting the economy or Canadian bank earnings (expected to rise 5.5% in the next year).

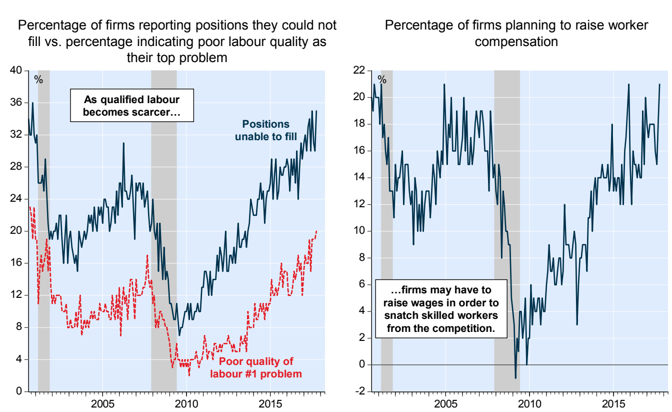
Perspective on the prime-aged workforce
Employment for people aged 25-54: Canada vs. the U.S.



NBF Economics and Strategy (data via Datastream)

And what about NAFTA? Its termination would obviously be a major setback for Canada and Mexico. But it would also hinder the outlook for U.S. profits and the U.S. labour market: nearly 9 million U.S. jobs depend on trade with and investment in Canada, and for 35 states Canada is the number-one export market. In our view, the best argument against terminating NAFTA is the continued improvement of the U.S. labour market and the resulting U.S. labour shortages (chart).

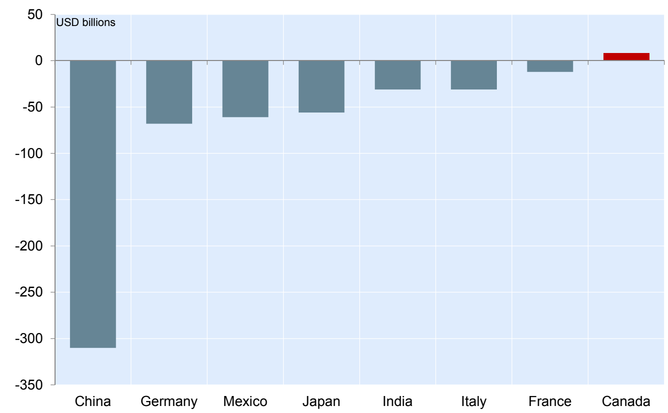
U.S.: NFIB small business report show qualified workers in short supply



NBF Economics and Strategy (data via Datastream)

In these circumstances and given the relatively small trade deficit the U.S. is running with its NAFTA partners — with Canada it is running a surplus — our baseline scenario does not include repudiation of NAFTA.

U.S.: Is NAFTA such a bad deal?
U.S. trade balance for goods and services - 2016



NBF Economics and Strategy (data via U.S. Department of Commerce)

Asset allocation

Our asset allocation is unchanged this month. We continue to prefer stocks over bonds. Though monetary policy is set to normalize further in many countries in 2018, we do not expect it to become restrictive any time soon. Also, U.S. rebuilding after severe hurricane damage, coupled with Washington's proposed individual and corporate tax cuts, are likely to keep the global economy strong enough for companies to deliver on expected earnings.

Sector rotation

Our sector allocation is unchanged this month.

NBF Asset Allocation

	Benchmark (%)	NBF Recommendation (%)	Change (pp)
Equities			
Canadian Equities	20	24	
U.S. Equities	20	17	
Foreign Equities (EAFE)	5	8	
Emerging markets	5	5	
Fixed Income	45	39	
Cash	5	7	
Total	100	100	

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Monthly Equity Monitor

NATIONAL BANK OF CANADA FINANCIAL MARKETS

NBF Market Forecast *Canada*			
		Actual	***Q22018 (Est.)***
Index Level		**Nov-24-17**	***Target***
S&P/TSX		16,108	16,700
Assumptions			Q22018 (Est.)
Level:	Earnings *	889	940
	Dividend	460	487
PE Trailing (implied)		18.1	17.8
			Q22018 (Est.)
Treasury Bills (91 days)		0.87	1.68
10-year Bond Yield		1.89	2.70

** Before extraordinary items, source Thomson*

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NBF Market Forecast *United States*			
		Actual	***Q22018 (Est.)***
Index Level		**Nov-24-17**	***Target***
S&P 500		2,602	2,670
Assumptions			Q22018 (Est.)
Level:	Earnings *	129	136
	Dividend	50	53
PE Trailing (implied)		20.2	19.6
			Q22018 (Est.)
Treasury Bills (91 days)		1.26	1.74
10-year Bond Yield		2.34	2.80

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

NBF Fundamental Sector Rotation - December 2017

Name (Sector/Industry)	Recommendation	S&P/TSX weight
Energy	**Overweight**	**19.5%**
Energy Equipment & Services	Overweight	0.6%
Oil, Gas & Consumable Fuels	Overweight	18.9%
Materials	**Market Weight**	**11.3%**
Chemicals	Underweight	2.1%
Containers & Packaging	Market Weight	0.5%
Metals & Mining *	Overweight	2.8%
Gold	Market Weight	5.2%
Paper & Forest Products	Overweight	0.6%
Industrials	**Market Weight**	**9.4%**
Capital Goods	Overweight	2.2%
Commercial & Professional Services	Underweight	1.6%
Transportation	Market Weight	5.6%
Consumer Discretionary	**Underweight**	**5.5%**
Automobiles & Components	Underweight	1.3%
Consumer Durables & Apparel	Overweight	0.6%
Consumer Services	Underweight	1.2%
Media	Market Weight	1.0%
Retailing	Underweight	1.4%
Consumer Staples	**Underweight**	**3.7%**
Food & Staples Retailing	Underweight	2.8%
Food, Beverage & Tobacco	Underweight	0.8%
Health Care	**Market Weight**	**0.7%**
Health Care Equipment & Services	Market Weight	0.2%
Pharmaceuticals, Biotechnology & Life Sciences	Market Weight	0.5%
Financials	**Market Weight**	**34.9%**
Banks	Market Weight	23.9%
Diversified Financials	Market Weight	4.0%
Insurance	Market Weight	7.0%
Information Technology	**Overweight**	**3.3%**
Software & Services	Overweight	2.9%
Technology Hardware & Equipment	Market Weight	0.5%
Telecommunication Services	**Underweight**	**4.9%**
Utilities	**Underweight**	**3.8%**
Real Estate	**Underweight**	**2.9%**

** Metals & Mining excluding the Gold Sub-Industry for the recommendation.*

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