NATIONAL BANK OF CANADA
FINANCIAL MARKETS

February 2019

Highlights

By Stéfane Marion / Matthieu Arseneau

- Global equity markets rebounded smartly in January. The 7.1% jump of the MSCI ACWI was the biggest monthly increase since October 2015. Deteriorating earnings expectations have combined with a stock market rebound to push the MSCI ACWI forward P/E back up to 14 from a December 24 low of 12.4. In other words, the rise of equity indexes in recent weeks is due entirely to P/E expansion. So what's fuelling the current optimism of equity markets? Dovish central banks and expectations of a trade deal between the U.S. and China.

- U.S. equity markets, after anticipating a major economic slowdown just a few weeks ago, are rebounding on the back of better-than-expected economic data. This is not to say GDP growth won't slow in 2019 – we expect 1.9% Q4/Q4, down from 3.1% in 2018 – but we don't see a contraction. With earnings showing signs of stabilizing, companies are less likely to cut back on investment and headcounts. That is key to keeping the economic expansion going. At this writing, the bottom-up consensus of equity analysts expects S&P 500 earnings per share to grow 5.7% in 2019. This estimate is in line with that for sales growth, implying no profit-margin expansion in 2019 (as we have been forecasting for the past few months). We find these expectations to be reasonable, especially in a time of USD depreciation.

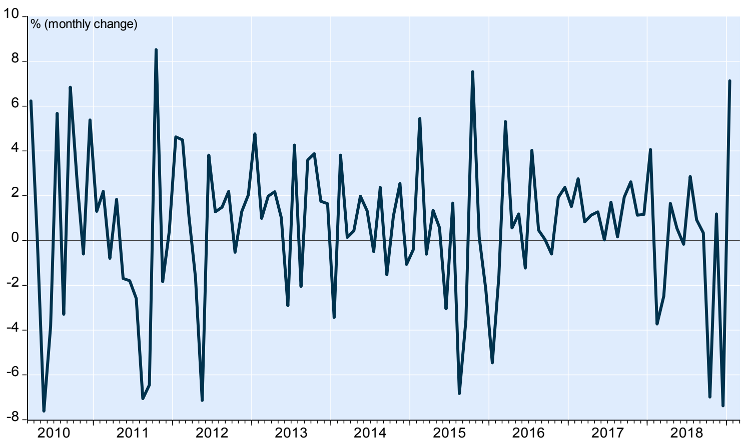
- After a dismal performance in 2018, the S&P/TSX surged more than 8% in January, the best beginning of a year in 32 years. As we go to press, the S&P/TSX is trading at about **13.7 times** forward earnings, up from less than 12 on December 24, 2018. That's a 14% increase! In fact it was the largest P/E expansion among global regions so far in 2019.

- The recent surge has left the S&P/TSX closing in on our target and a consensus outlook of EPS growth exceeding ours (9.6% vs. 6%). With upside less compelling, we are scaling back our S&P/TSX position, while keeping it slightly overweight because of our currency forecast of 1.27CAD/USD. We recommend using some of the proceeds from this trade to reduce our underweighting of the S&P 500 (where EPS and sales growth are now better aligned). We are also raising our cash recommendation to slightly overweight as we await confirmation of a U.S.-China trade truce/deal that will avert the imposition of new tariffs on March 1.

World: Dovish central banks

Global equity markets rebounded smartly in January. The 7.1% jump of the MSCI ACWI was the biggest monthly increase since October 2015. Interestingly, all main global regions were up on the month, led by North America and Emerging Markets. Among sectors, it is interesting to note that cyclical stocks have gained impressively despite lacklustre economic data.

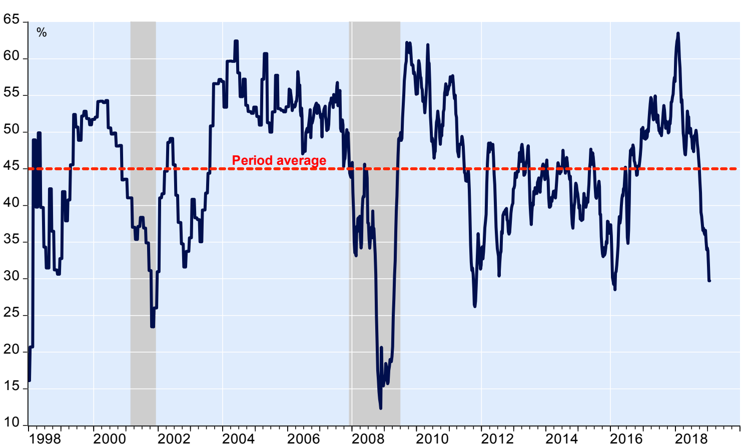
World: A big rebound in January
MSCI ACWI monthly price return



NBF Economics and Strategy (data via Refinitiv)

The slowing of economic growth has taken a toll on earnings expectations. As the chart below shows, earnings have been revised up for only 30% of companies in the MSCI ACWI, the worst showing since 2016.

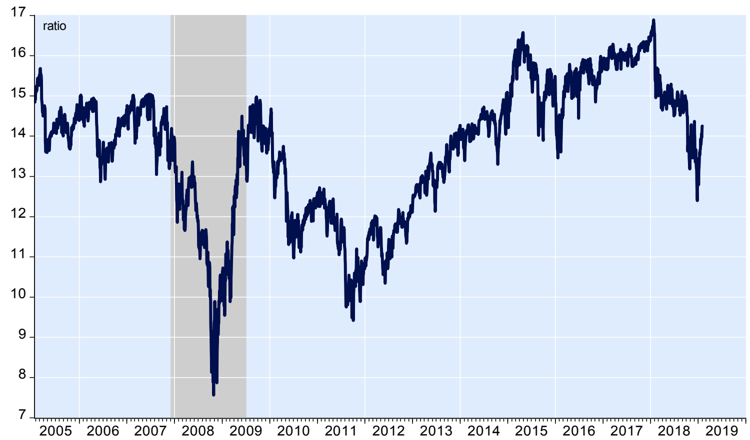
World: Diffusion for earnings revision still deteriorating
Companies in MSCI AC with upward revision as a share of total earnings revisions



NBF Economics and Strategy (data via Refinitiv)

Deteriorating earnings expectations have combined with a stock market rebound to push the MSCI ACWI forward P/E back up to 14 from a December 24 low of 12.4. In other words, the rise of equity indexes in recent weeks is due entirely to P/E expansion. Since multiple expansion is limited in the mature phase of an economic cycle, we need better economic news in the coming weeks to keep markets trending up.

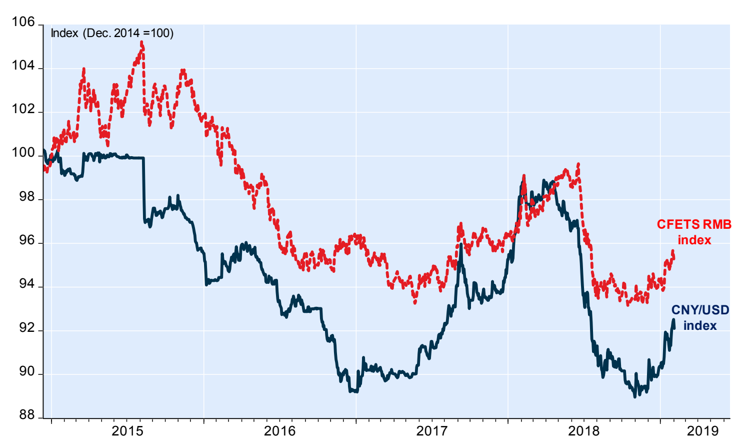
World: Forward PE back above 14
12-month forward PE for the MSCI ACWI



NBF Economics and Strategy (data via Refinitiv)

So what's fuelling the current optimism of equity markets? Dovish central banks and expectations of a trade deal between the U.S. and China. Though the U.S. Federal Reserve left its fed funds rate unchanged in late January, it altered its communication significantly by removing from its press release the sentence about further gradual increases in the fed funds rate. The Fed now says "the Committee will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate." These dovish comments from the U.S. central bank come on the heels of monetary easing in China and just as U.S.-China trade discussions enter a crucial period. Though much work remains to be done before the March 1 deadline set by the U.S. to hike tariffs on more Chinese products, the two belligerents seem to be serious about a ceasefire. Bloomberg reports that China bought 2 million tons of U.S. soybeans on January 31. A pleased President Trump said Beijing had agreed to buy more and he was planning to meet the Chinese president before the end of February. The CNY reacted positively to the news, rising against both the USD and a basket of 24 currencies (chart).

China: Currency is strengthening
Trade-weighted index of RMB vs. 24 currencies vs. the CNY/USD index



NBF Economics and Strategy (Federal Reserve data via Refinitiv)

The strengthening of the Chinese currency was echoed by a firming of commodity prices in the last week of January. WTI rose 2.9%, lumber rebounded 9.9% and iron ore 14.9%. There is upside remaining in commodity prices if a trade war is avoided and the global economy expands 3.5% in 2019 as we think it will (see our latest *Monthly Economic Monitor* for more details).

World: Commodities are rising again
Iron ore (Fe 63.5%)

NBF Economics and Strategy (data via Refinitiv)

The recent wave of downward earnings revisions has left the bottom-up consensus of equity analysts expecting EPS growth of 6.1% for the MSCI AC in 2019 (table). These expectations are reasonable if there is forward movement in Beijing-Washington trade talks, especially given the recent decline of long-term interest rates and the halt of USD appreciation.

MSCI composite index: EPS Performance

	2017	2018	2019	2020	12 months forward
MSCI ACWI	17.6	14.4	6.1	10.1	6.6
MSCI World	16.6	15.2	6.0	9.7	6.5
MSCI USA	12.0	23.8	5.9	11.2	6.8
MSCI Canada	28.4	11.3	8.2	11.2	8.8
MSCI Europe	15.8	6.1	7.4	8.4	7.4
MSCI Pacific ex Jp	16.1	8.5	4.2	6.3	5.3
MSCI Japan	NA	39.0	1.1	2.7	2.6
MSCI EM	24.0	10.4	7.1	12.0	7.3
MSCI EM EMEA	12.3	21.4	6.3	9.9	6.2
MSCI EM Latin America	19.8	12.0	18.0	9.3	17.1
MSCI EM Asia	27.6	7.8	5.7	12.9	6.2

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NBF Economics and Strategy (data via Datastream)

U.S.: The economy remains resilient

U.S. equity markets, after anticipating a major economic slowdown just a few weeks ago, are rebounding on the back of better-than-expected economic data. This is not to say GDP growth won't slow in 2019 – we expect 1.9% Q4/Q4, down from 3.1% in 2018 – but we don't see a contraction. We have kept our 2019 growth forecast unchanged throughout the recent bout of volatility in financial markets.

U.S.: Economic surprises turn positive
CITI economic surprise indices

NBF Economics and Strategy (data via Bloomberg)

We argued in last month's *Equity Monitor* that a stabilization of markets would require signs of resilience in the economy and earnings, a steeper yield curve, a weaker U.S. dollar and more visibility of a U.S.-China trade armistice. Things have moved in the right direction on most of these accounts (the exception is the yield curve, which remains flatter than we would like).

Employment growth remained strong in January with a net addition of 304,000 payroll jobs. With 12-month wage inflation running at 3.2%, we expect household spending to remain resilient in the months ahead. As for Q4 profits, things are actually not so bad. At this writing, just about halfway through the announcement season, 74% of the S&P 500 companies have reported better-than-expected earnings and 60% have reported better revenues (table).

U.S.: Q4 2018 earnings season
S&P 500 earnings season

		Sales Surprise				Earnings Surprise			
Industry (ICB)	Reported	Positive	Inline	Negative	%	Positive	Inline	Negative	%
All Securities	235 / 500	140	0	95	0.57%	172	4	57	2.84%
>Oil & Gas	10 / 30	7	0	3	1.23%	7	0	2	22.62%
>Basic Materials	10 / 17	1	0	9	-3.04%	5	0	5	-3.05%
>Industrials	53 / 88	37	0	16	1.58%	48	0	5	3.28%
>Consumer Goods	22 / 59	11	0	11	-1.66%	13	1	7	3.23%
>Health Care	26 / 52	20	0	6	0.82%	21	0	5	2.43%
>Consumer Services	24 / 67	16	0	8	1.29%	21	0	3	5.60%
>Telecommunications	2 / 3	0	0	2	-0.79%	1	1	0	1.23%
>Utilities	5 / 27	3	0	2	-3.66%	2	0	3	-0.65%
>Financials	59 / 103	32	0	27	-0.36%	34	2	23	-0.56%
>Technology	23 / 52	12	0	11	0.24%	19	0	4	2.51%

Bloomberg (as of February 1, 2019)

With earnings showing signs of stabilizing, companies are less likely to cut back on investment and headcounts. That is key to keeping the economic expansion going. At this writing, the bottom-up consensus of equity analysts expects S&P 500 earnings per share to grow 5.7% in 2019 (table). This estimate is in line with that for sales growth, implying no profit-margin expansion in 2019 (as we have been forecasting for the past few months). We find these expectations to be reasonable, especially in a time of USD depreciation.

S&P 500 composite index: EPS Performance

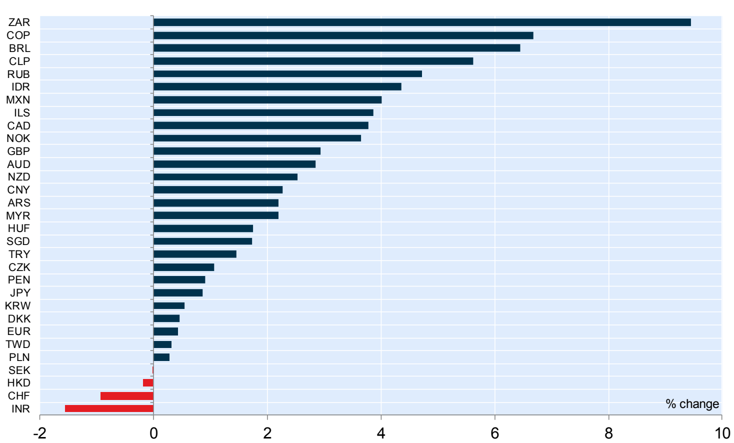
	2017	2018	2019	2020	12 months forward
S&P 500	11.8	23.6	5.7	11.1	6.6
ENERGY	351.4	92.5	-5.3	27.6	-2.7
MATERIALS	14.6	25.6	4.5	12.1	5.2
INDUSTRIALS	4.6	19.5	10.4	11.2	10.7
CONS. DISC.	6.1	19.5	9.3	13.6	9.5
CONS. STAP.	6.4	10.8	4.2	7.3	4.7
HEALTH CARE	8.1	16.0	7.1	9.9	7.4
FINANCIALS	7.0	29.8	9.1	9.5	9.2
IT	20.6	26.0	3.0	10.3	5.4
TELECOM	5.5	21.7	5.4	10.6	6.1
UTILITIES	3.0	8.0	5.3	5.2	5.3
REAL ESTATE	-10.9	-1.3	-11.5	9.1	-10.0

2/1/2019

NBF Economics and Strategy (data via Datastream)

The Fed's dovish turn is certainly supportive of risk assets and USD depreciation. All but four of 31 major currencies have gained against the greenback since the most recent low of the S&P 500 on December 24 (chart).

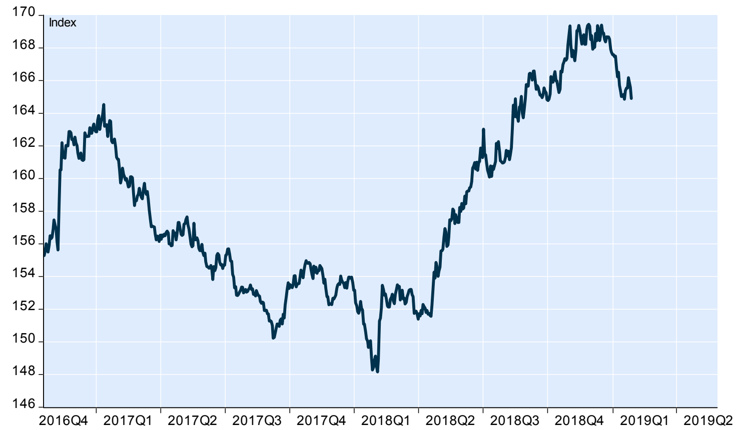
World: Greenback remains under pressure
Spot return against USD since December 24, 2018 (as of February 1, 2019)



NBF Economics and Strategy (data via Bloomberg)

U.S.-dollar weakness has been most pervasive against emerging-market currencies (chart).

U.S.: The greenback depreciates most against EM currencies
Trade-weighted index of USD vs. basket of 19 emerging markets currencies

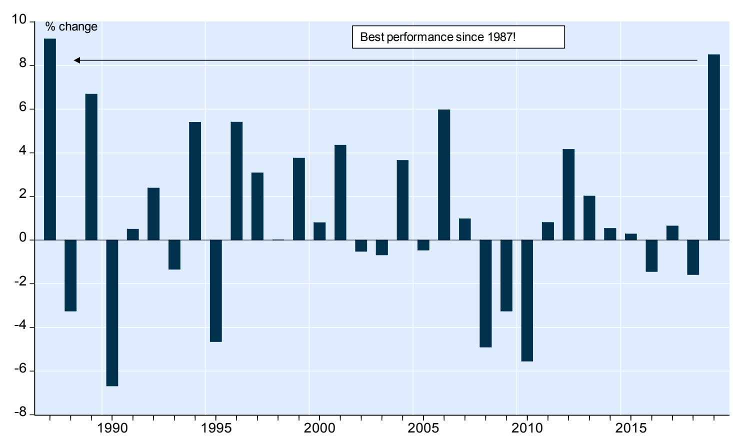


NBF Economics and Strategy (Federal Reserve data via Refinitiv)

Canada: First out of the blocks in 2019

After a dismal performance in 2018, the S&P/TSX surged more than 8% in January, the best beginning of a year in 32 years (chart).

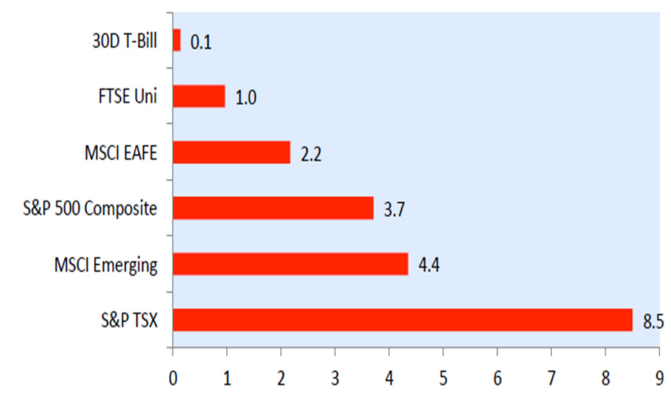
S&P TSX: Perspective on stock market performance in January



NBF Economics and Strategy (data via Refinitiv)

At this writing the index is already up 8.5% on a total return basis, surpassing all other asset classes in Canadian-dollar terms (chart). Most sectors of the S&P/TSX have done well in recent weeks, with Health Care, Energy and IT showing double-digit gains. Our decision to stick with an overweight recommendation for the S&P/TSX was the right one but we had not seen a gain of this magnitude in such a short time.

Canada: Perspective asset classes performance
YTD total return (% in CAD as of February 1, 2019)



NBF Economics and Strategy (data via Refinitiv)

S&P/TSX composite index: Price Performance

	Month to date	Quarter to date	Year to date
S&P TSX	-0.2	8.3	8.3
HEALTH CARE	1.7	45.7	45.7
IT	0.5	10.5	10.5
TELECOM	0.2	4.7	4.7
CONS. STAP.	0.2	3.6	3.6
UTILITIES	0.1	6.2	6.2
REAL ESTATE	-0.1	7.5	7.5
INDUSTRIALS	-0.2	7.2	7.2
ENERGY	-0.2	10.3	10.3
FINANCIALS	-0.3	7.6	7.6
BANKS	-0.3	8.3	8.3
CONS. DISC.	-0.8	9.8	9.8
MATERIALS	-0.8	5.8	5.8

2/1/2019

NBF Economics and Strategy (data via Datastream)

As we go to press, the S&P/TSX is trading at about **13.7 times** forward earnings, up from less than 12 on December 24, 2018. That's a 14% increase!

S&P/TSX : Price to 12-month forward earnings

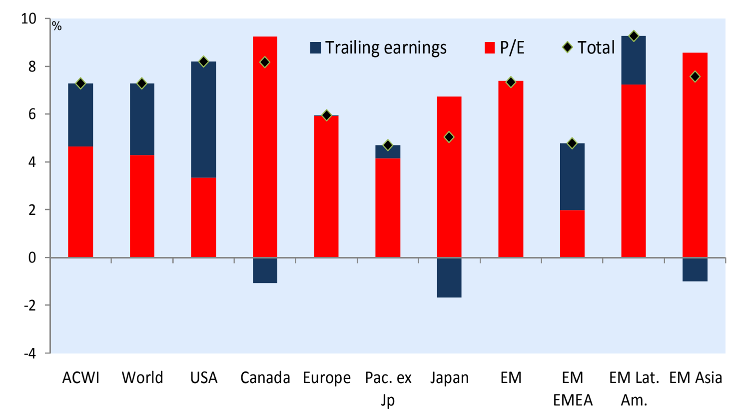
	2/1/2019	A year ago	10 year ave.	5 year average
S&P TSX	13.7	15.6	14.5	15.5
ENERGY	15.6	21.0	23.4	30.1
MATERIALS	18.6	19.3	17.6	20.9
INDUSTRIALS	16.4	17.4	15.3	16.4
CONS. DISC.	12.1	15.1	13.3	14.1
CONS. STAP.	16.0	16.5	15.6	17.2
HEALTH CARE	24.8	14.8	13.7	12.6
FINANCIALS	10.1	12.2	11.6	11.8
BANKS	10.1	11.9	11.0	11.1
IT	24.2	23.6	17.1	20.7
TELECOM	15.6	15.9	14.4	16.0
UTILITIES	18.0	17.9	18.1	19.1
REAL ESTATE	13.2	NA	NA	NA

2/1/2019

NBF Economics and Strategy (data via Datastream)

In fact it was the largest P/E expansion among global regions so far in 2019 (chart).

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



NBF Economics and Strategy (data via Datastream)

So where do we go from here? As the table below shows, the bottom-up consensus sees EPS growth of 9.6% in 2019. That's almost double the expected increase in sales. We find these expectations a bit rich in light of our forecast of some further CAD appreciation in the coming months (to 1.27 CAD/USD) and Bank of Canada rate hikes (as detailed in our latest monthly *Forex* and *Fixed Income Monitor*).

S&P/TSX composite index: EPS Performance

	2017	2018	2019	2020	12 months forward
S&P TSX	30.7	10.9	9.6	12.1	10.0
ENERGY	483.6	23.6	12.7	17.3	13.1
MATERIALS	63.2	-4.1	13.5	22.6	14.4
INDUSTRIALS	17.4	6.5	18.0	17.2	18.0
CONS. DISC.	15.0	15.9	9.3	11.3	9.6
CONS. STAP.	12.0	11.4	8.3	11.9	9.8
HEALTH CARE	-30.1	-26.1	68.3	18.0	36.5
FINANCIALS	15.3	11.3	7.2	8.2	8.3
BANKS	10.4	12.2	5.8	6.8	6.1
IT	13.3	18.1	13.1	13.0	13.5
TELECOM	5.9	7.8	7.1	7.3	6.8
UTILITIES	-8.5	9.3	14.9	9.3	14.3
REAL ESTATE	20.9	14.7	-11.2	7.6	-10.6

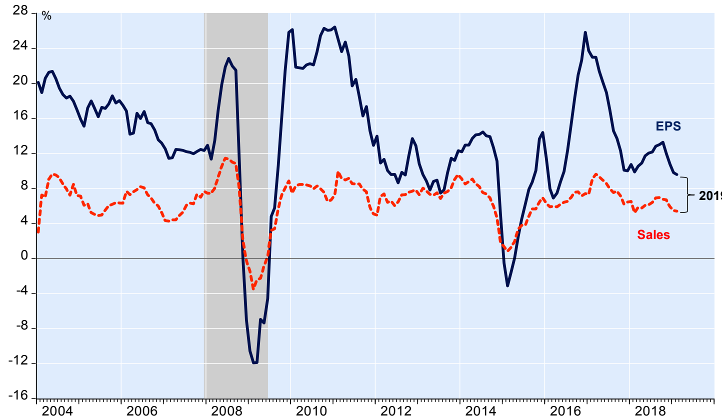
2/1/2019

NBF Economics and Strategy (data via Datastream)

Asset allocation

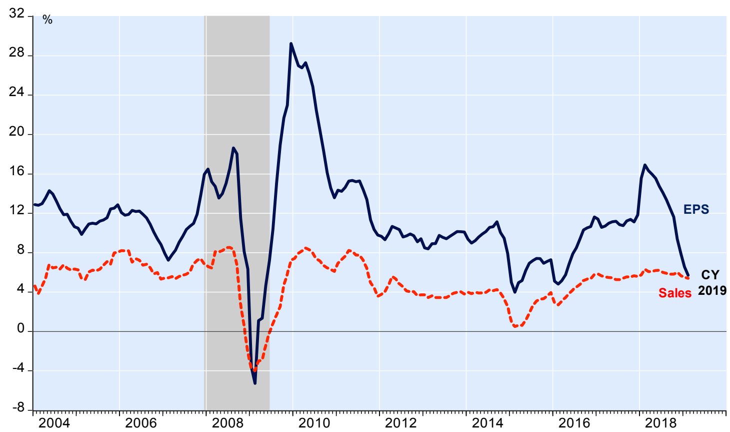
This month we alter our asset allocation to reflect the outsized gains of global equity markets so far this year. In our January *Equity Monitor* we set a target of 12% growth for the S&P/TSX by year end, based on a P/E of 14.7 and EPS growth of 6%. The recent surge has left the S&P/TSX closing in on our target and a consensus outlook of EPS growth exceeding ours (9.6% vs. 6%). With upside less compelling, we are scaling back our S&P/TSX position, while keeping it slightly overweight because of our currency forecast of 1.27CAD/USD. We recommend using some of the proceeds from this trade to reduce our underweighting of the S&P 500 (where EPS and sales growth are now better aligned). We are also raising our cash recommendation to slightly overweight as we await confirmation of a U.S.-China trade truce/deal that will avert the imposition of new tariffs on March 1.

S&P/TSX: Perspective on bottom-up consensus expectations
12-month forward earnings per share and sales growth expectations



NBF Economics and Strategy (data via Refinitiv)

S&P 500: Perspective on bottom-up consensus expectations
12-month forward earnings per share and sales growth expectations



NBF Economics and Strategy (data via Refinitiv)

NBF Asset Allocation

	Benchmark (%)	NBF Recommendation (%)	Change (pp)
Equities			
Canadian Equities	20	21	-3
U.S. Equities	20	19	+1
Foreign Equities (EAFE)	5	8	
Emerging markets	5	6	
Fixed Income	45	39	
Cash	5	7	+2
Total	100	100	

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Sector rotation

Our sector rotation remains unchanged this month.

NATIONAL BANK OF CANADA FINANCIAL MARKETS

NBF Market Forecast
Canada

		Actual	Q42019(Est.)
Index Level		**Feb-01-19**	***Target***
S&P/TSX		15,506	16,200
Assumptions			Q42019(Est.)
Level:	Earnings *	1025	1100
	Dividend	491	527
PE Trailing (implied)		15.1	14.7
			Q42019(Est.)
10-year Bond Yield		1.96	2.67

** Before extraordinary items, source Thomson*

NBF Economics and Strategy

NBF Market Forecast
United States

		Actual	Q42019(Est.)
Index Level		**Feb-01-19**	***Target***
S&P 500		2,707	2,840
Assumptions			Q42019(Est.)
Level:	Earnings *	160	169
	Dividend	54	57
PE Trailing (implied)		16.9	16.8
			Q42019(Est.)
10-year Bond Yield		2.69	3.34

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

NBF Fundamental Sector Rotation - February 2019

Name (Sector/Industry)	Recommendation	S&P/TSX weight
Energy	**Overweight**	**18.0%**
Energy Equipment & Services	Overweight	0.5%
Oil, Gas & Consumable Fuels	Overweight	17.6%
Materials	**Overweight**	**11.5%**
Chemicals	Market Weight	2.2%
Containers & Packaging	Market Weight	0.5%
Metals & Mining *	Overweight	2.6%
Gold	Overweight	5.6%
Paper & Forest Products	Market Weight	0.5%
Industrials	**Underweight**	**10.6%**
Capital Goods	Market Weight	1.9%
Commercial & Professional Services	Underweight	2.6%
Transportation	Underweight	6.2%
Consumer Discretionary	**Underweight**	**4.3%**
Automobiles & Components	Underweight	1.1%
Consumer Durables & Apparel	Overweight	0.8%
Consumer Services	Underweight	1.4%
Retailing	Underweight	1.0%
Consumer Staples	**Market Weight**	**3.8%**
Food & Staples Retailing	Market Weight	3.1%
Food, Beverage & Tobacco	Market Weight	0.7%
Health Care	**Market Weight**	**2.1%**
Health Care Equipment & Services	Market Weight	0.2%
Pharmaceuticals, Biotechnology & Life Sciences	Market Weight	1.9%
Financials	**Overweight**	**32.6%**
Banks	Overweight	23.4%
Diversified Financials	Market Weight	3.2%
Insurance	Overweight	6.0%
Information Technology	**Underweight**	**4.1%**
Software & Services	Underweight	4.0%
Technology Hardware & Equipment	Underweight	0.1%
Telecommunication Services	**Underweight**	**5.8%**
Utilities	**Underweight**	**4.0%**
Real Estate	**Underweight**	**3.2%**

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

NATIONAL BANK OF CANADA FINANCIAL MARKETS

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