NATIONAL BANK OF CANADA
FINANCIAL MARKETS

Monthly Equity Monitor

Economics and Strategy

January/February 2018

Highlights

- After a spectacular 2017 that saw global equities return more than 17.5%, the MSCI All Country index has continued to do extremely well early in 2018 with a gain of 5.7% year to date. The rally is still fuelled mainly by better-than-expected profits: 63% of MSCI AC constituents whose forward earnings have been revised have enjoyed an upward adjustment, the best diffusion in more than two decades.
- In the U.S., a strong economy coupled with the Trump administration's recent success in implementing its pro-business agenda of tax cuts and deregulation has surprised market watchers and fuelled enthusiasm for the U.S. earnings outlook. The bottom-up consensus of equity analysts has revised up the forward EPS of the S&P 500 by 4% in the last four weeks, the biggest-ever one-month upward revision.
- As the U.S. economy enters its 122nd month since the pre-recession peak, we continue to think that conditions are in place to make this business cycle the longest ever. Most importantly, the yield curve remains steep for this point in the cycle (i.e. when the output gap has become positive).
- The S&P TSX has been slow out of the gate in 2018, gaining only 0.2% over the first three weeks of January. As noted in our December *Equity Monitor*, the performance of the S&P/TSX in 2018 will depend on the global economy and commodity prices and on the resilience of bank profits in the face of rising interest rates. S&P/TSX earnings revisions have turned upward in recent weeks.
- Our asset allocation is unchanged this month. The current yield spread between the 10-year Treasury and the 3-month T-bill, at more than 110 bps, is well above the 50 bps that in the past has been the threshold of a signal heralding lacklustre performance of U.S. equities and rising odds of a bear market.

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World: How much upside in 2018?

After a spectacular 2017 that saw global equities return more than 17.5%, the MSCI All Country index has continued to do extremely well early in 2018 with a gain of 5.7% year to date. All the main regions have contributed, with the U.S. and emerging countries leading the pack (table).

MSCI composite index: Price Performance

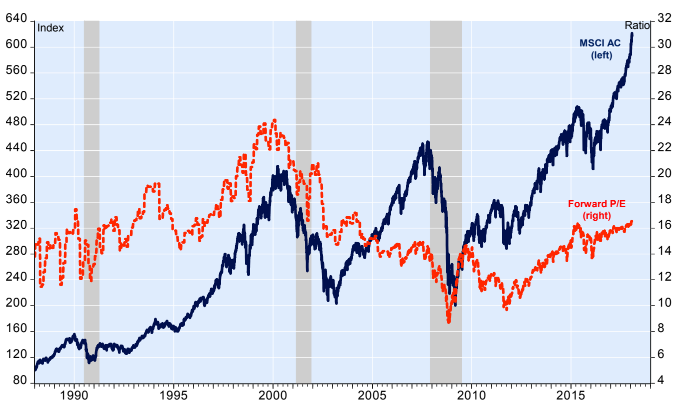
	Month to date	Quarter to date	Year to date
MSCI AC World	3.5	3.5	3.5
MSCI World	3.5	3.5	3.5
MSCI USA	4.2	4.2	4.2
MSCI Canada	1.0	1.0	1.0
MSCI Europe	2.5	2.5	2.5
MSCI Pacific ex Jp	1.2	1.2	1.2
MSCI Japan	3.5	3.5	3.5
MSCI EM	3.6	3.6	3.6
MSCI EM EMEA	2.1	2.1	2.1
MSCI EM Latin America	2.6	2.6	2.6
MSCI EM Asia	4.1	4.1	4.1

1/12/2018

NBF Economics and Strategy (data via Datastream)

At this writing the MSCI AC is trading at an all-time high of just over 621. It is still fuelled mainly by better-than-expected profits.

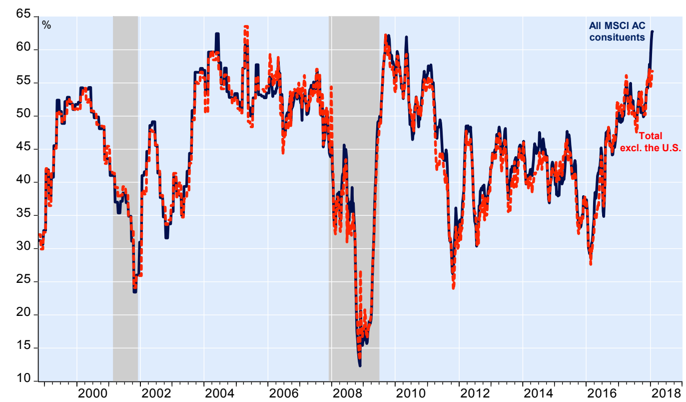
World: Global equities at a record high
MSCI AC and its 12-month-forward P/E



NBF Economics and Strategy (data via Datastream)

Global earnings expectations have been revised up a whopping 2% in the past month alone. The last time revisions were this upbeat was in 2010, when the global economy was coming out of recession. Importantly, the January revisions were broad-based. As the chart below shows, 63% of MSCI AC constituents whose forward earnings have been revised by equity analysts have enjoyed an upward adjustment,[1] the best diffusion in more than two decades.

World: Diffusion is the best in two decades for earnings
Share of MSCI AC constituents with earnings revisions that are positive*



* Companies with upward revisions as a share of total revisions (up + down).
NBF Economics and Strategy (data via Datastream)

Encouragingly, the one-month diffusion of earnings revisions is well above the 10-year average for all the main regions of the world (table). The combination of fiscal stimulus (tax cuts or increased government spending), higher commodity prices, low interest rates and the homeowner wealth effect of higher home prices appears to have rekindled animal spirits, prompting households and businesses to spend more.

MSCI : Change in 12-month forward earnings

	3-month change		1-month change		1-month diffusion (% up)	
	3-month change	10 year historical average	1-month change	10 year historical average	1 month diffusion	10 year historical average
MSCI AC World	2.9	-0.8	2.1	-0.8	63%	43%
MSCI World	3.0	-0.8	2.4	-0.8	68%	44%
MSCI USA	4.3	-0.7	3.9	-0.7	79%	46%
MSCI Canada	1.3	-0.8	1.8	-0.8	70%	43%
MSCI Europe	0.5	-1.1	0.5	-1.1	54%	39%
MSCI Pacific ex Jp	1.5	-0.6	1.0	-0.6	67%	42%
MSCI Japan	4.4	-0.9	0.6	-0.9	67%	49%
MSCI EM	2.1	-0.6	0.5	-0.6	52%	41%
MSCI EM EMEA	4.4	-0.6	2.6	-0.6	51%	42%
MSCI EM Latin America	0.9	-0.9	0.2	-0.9	52%	40%
MSCI EM Asia	1.8	-0.4	0.1	-0.4	52%	42%

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[1] The MSCI AC has about 2,500 constituents.

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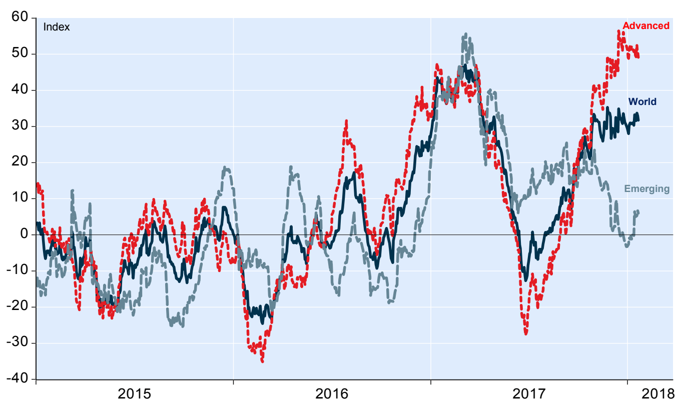
With the world economy continuing to surprise on the upside in both developed and emerging countries, global earnings expectations for the coming year may have further upside. This is the key for maintaining an uptrend in equity indexes, since there is limited room for P/E expansion at this point in the cycle when long-term interest rates are rising.

World: Economy continues to surprise on the upside
Citi Economic Surprise Index



NBF Economics and Strategy (data via Bloomberg)

U.S.: Highest P/Es in two decades

The year has begun with U.S. equities still on a tear. The S&P 500 was up 7.5% by January 26, with robust returns from all sectors but the more interest-sensitive: Telecoms, real estate and Utilities.

S&P 500 composite index: Price Performance

	Month to date	Quarter to date	Year to date
S&P 500	7.5	7.5	7.5
HEALTH CARE	10.8	10.8	10.8
CONS. DISC.	10.5	10.5	10.5
IT	8.8	8.8	8.8
FINANCIALS	8.1	8.1	8.1
ENERGY	7.5	7.5	7.5
INDUSTRIALS	6.4	6.4	6.4
MATERIALS	6.0	6.0	6.0
CONS. STAP.	3.0	3.0	3.0
TELECOM	0.5	0.5	0.5
REAL ESTATE	-2.4	-2.4	-2.4
UTILITIES	-3.1	-3.1	-3.1

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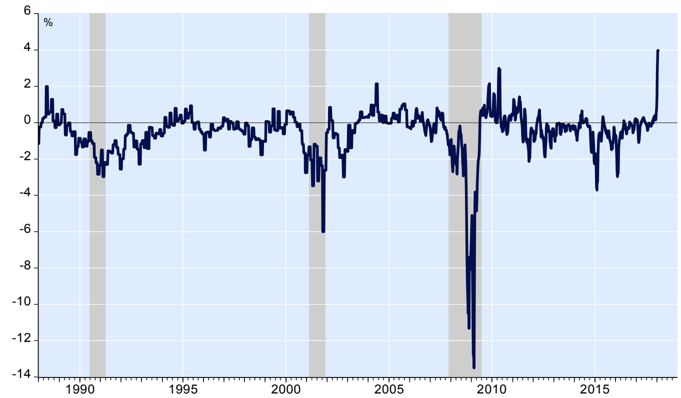
NBF Economics and Strategy (data via Datastream)

A strong economy coupled with the Trump administration's recent success in implementing its pro-business agenda of tax cuts and deregulation has surprised market watchers and fuelled enthusiasm for the U.S. earnings outlook. The bottom-up consensus of equity analysts has revised up the forward EPS of the S&P 500 by 4% in the last four weeks, the biggest-ever one-month upward revision (chart).

S&P 500: Profits revisions are the best ever
1-month change in 12-month forward earnings for the S&P 500



NBF Economics and Strategy (data via Bloomberg)

The revisions have been widespread, with record double-digit upgrades for Energy and Financial earnings in the past month. Real estate and Utilities are the only main sectors of the S&P 500 whose earnings outlook has not improved appreciably — a consequence of rising 10-year Treasury yields.

S&P 500 : Change in 12-month forward earnings

	3-month change		1-month change		1-month diffusion (% up)	
	3-month change	10 year historical average	1-month change	10 year historical average	1 month diffusion	10 year historical average
S&P 500	4.3	-2.3	4.0	-0.7	81%	46%
ENERGY	17.0	-6.5	10.4	-2.3	88%	40%
MATERIALS	2.0	-3.7	1.9	-1.2	88%	42%
INDUSTRIALS	1.1	-1.9	4.5	-0.6	93%	45%
CONS. DISC.	1.8	-2.8	3.5	-0.9	82%	47%
CONS. STAP.	2.1	-1.2	2.2	-0.3	100%	46%
HEALTH CARE	1.0	-0.4	1.8	-0.1	80%	51%
FINANCIALS	10.2	-4.4	10.0	-1.3	95%	44%
IT	4.4	-0.3	1.1	-0.1	68%	50%
TELECOM	1.9	-2.2	3.9	-0.6	100%	37%
UTILITIES	0.4	-0.8	0.2	-0.2	46%	44%
REAL ESTATE	-0.4	NA	-0.3	NA	38%	NA

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NBF Economics and Strategy (data via Datastream)

The recent string of earnings revisions takes S&P 500 earnings growth expectations in 2018 to 14.8%. The last time analysts were this bullish in the matured phase of the business cycle (i.e. when actual GDP is above its estimated potential) was in the late 1990s. So expectations are quite high.

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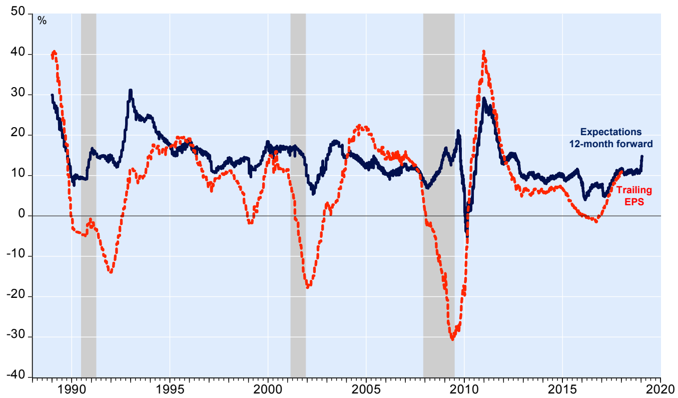
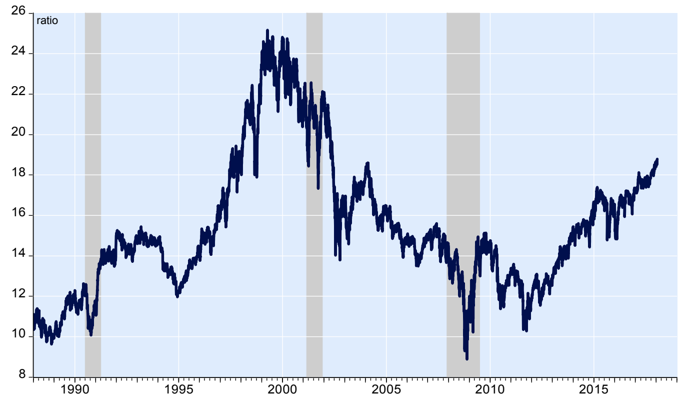
U.S.: Earnings growth vs. expectations
Trailing EPS for the S&P 500 vs. 12-month forward expectations



NBF Economics and Strategy (data via Datastream)

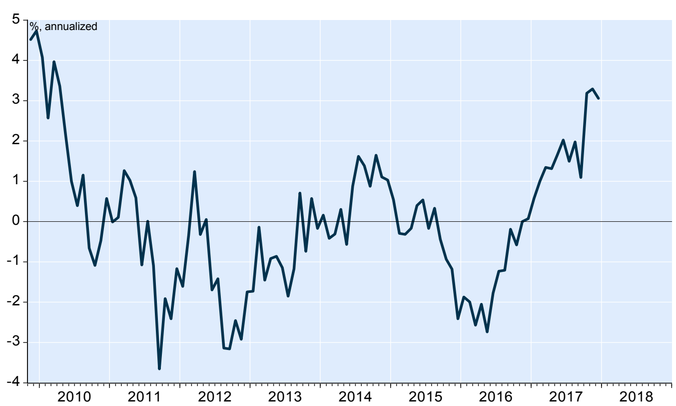
U.S.: The S&P 500 forward PE is the highest since 1997
S&P 500 12-month-forward P/E



NBF Economics and Strategy (data via Datastream)

At the same time, the outlook for the U.S. economy has firmed in recent months. The leading economic indicator (LEI) was at a new high in December. We're especially encouraged by the strength of the LEI's nonfinancial components – the "real economy." As the chart below shows, the real economy is contributing the most since 2010 to LEI strength. 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)

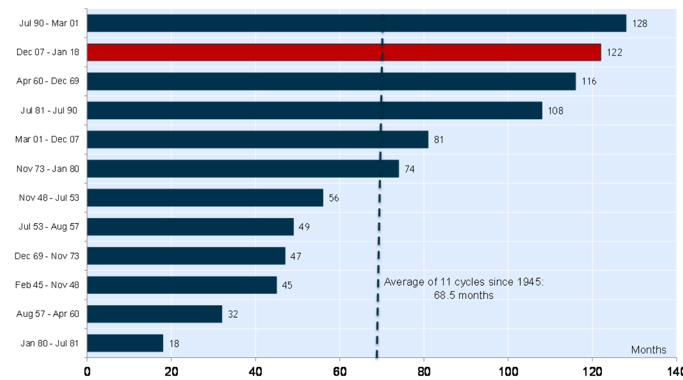


NBF Economics and Strategy (Conference Board data via Datastream)

Since valuations are not cheap, above-potential growth will be necessary if U.S. equities are to move higher. The S&P 500 is now trading at 19 times its forward P/E, a multiple exceeding the high of the previous business cycle (18.7 in 2004). The only precedent for a forward P/E exceeding 19 was in 1997-2000, a period coinciding with the matured phase of the longest business cycle in U.S. history (128 months).

As the U.S. economy enters its 122nd month since the pre-recession peak, we continue to think that conditions are in place to make this business cycle the longest ever.

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)

Most importantly, the yield curve remains steep for this point in the cycle (i.e. when the output gap has become positive), as unusually low inflation allows the central bank to normalize monetary policy much less aggressively than in past cycles.

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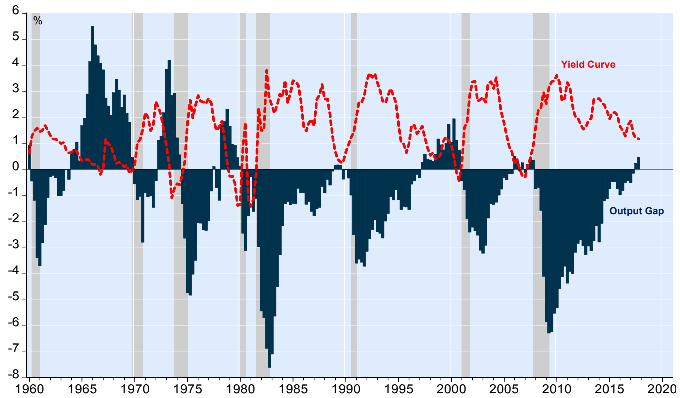
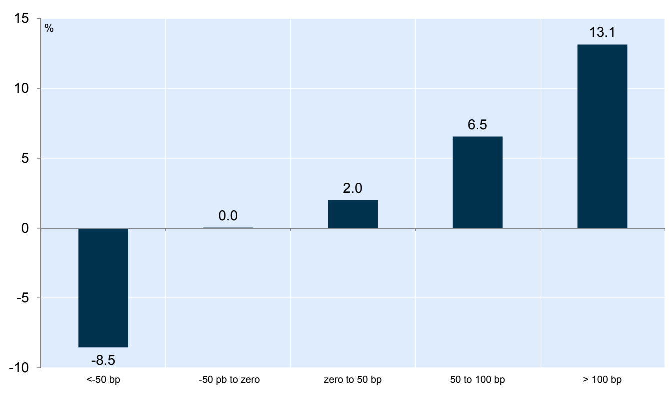
U.S.: Yield curve not that flat at this point in the cycle
Output gap* vs. yield curve (10-year Treasury yield less 3-month T Bill)



* Using potential GDP calculated by the Congressional Budget Office (CBO) - NBF Economics and Strategy (data via Datastream)

The current yield spread between the 10-year Treasury and the 3-month T-bill, at more than 110 bps, is well above the 50 bps that in the past has been the threshold of a signal heralding lacklustre performance of U.S. equities and rising odds of a bear market (chart). However, since the signal from the yield curve may have been muddied by successive rounds of quantitative easing by central banks, the curve slope may signal a bear market at a higher point than in the past. We have temporarily set 80 bps as the point below which we would turn cautious on equities.

S&P 500: Perspective on stock market performance
Average 6-month annualized performance depending of the slope of the yield curve in the mature phase



NBF Economics and Strategy (data via Datastream)

Canada: Slow off the blocks

The S&P TSX has been slow out of the gate in 2018, gaining only 0.2% over the first three weeks of January. While Materials, banks, IT and Health Care have done relatively well so far in the new year, the Canadian benchmark continues to be held back by Energy, Utilities, Industrials and Telecoms (table).

S&P/TSX composite index: Price Performance

	Month to date	Quarter to date	Year to date
S&P TSX	0.2	0.2	0.2
IT	6.3	6.3	6.3
HEALTH CARE	2.6	2.6	2.6
MATERIALS	2.4	2.4	2.4
BANKS	1.5	1.5	1.5
CONS. DISC.	1.3	1.3	1.3
CONS. STAP.	0.9	0.9	0.9
FINANCIALS	0.9	0.9	0.9
REAL ESTATE	0.3	0.3	0.3
ENERGY	-1.3	-1.3	-1.3
INDUSTRIALS	-1.7	-1.7	-1.7
UTILITIES	-3.6	-3.6	-3.6
TELECOM	-3.7	-3.7	-3.7

1/26/2018
NBF Economics and Strategy (data via Datastream)

As noted in our December *Equity Monitor*, the performance of the S&P/TSX in 2018 will depend on the global economy and commodity prices and on the resilience of bank profits in the face of rising interest rates. We note that at this writing the prices of copper, crude oil, natural gas and gold are higher than the averages assumed by analysts over the next year (table). If the global economy is as resilient as we think, the bottom-up analyst consensus will need to reshuffle its commodity price deck for 2018. That would mean upward revision of forward earnings.

Commodity prices expectations

Analyst Assumptions

	Copper	Gold	Crude Oil	Natural Gas
Current Price	**7085**	**1350**	**66**	**3.51**
Analyst assumptions				
Q+2	**6769**	**1270**	**59**	**3.03**
Q+4	**6875**	**1275**	**60**	**3.25**
Growth (Q_t/Q_0)				
Q+2	**-4.5%**	**-5.9%**	**-11.6%**	**-13.6%**
Q+4	**-3.0%**	**-5.5%**	**-9.3%**	**-7.3%**

Current Forward Prices

	Copper	Gold	Crude Oil	Natural Gas
Current Price	**7085**	**1350**	**66**	**3.51**
Forward prices				
Q+2	**7136**	**1370**	**64**	**2.95**
Q+4	**7176**	**1387**	**61**	**2.94**
Growth (Q_t/Q_0)				
Q+2	**0.7%**	**1.5%**	**-4.0%**	**-15.8%**
Q+4	**1.3%**	**2.8%**	**-8.5%**	**-16.1%**

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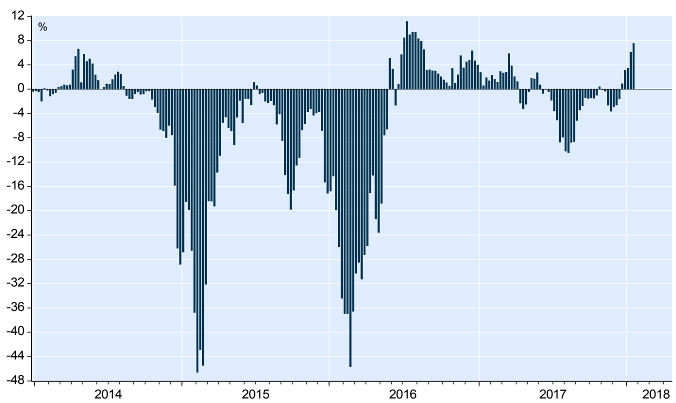
NBF Economics and Strategy (data via Datastream)

This is what we are starting to see. S&P/TSX earnings revisions have turned upward in recent weeks, led by Energy and Materials. The revisions for Energy are the best since the summer of 2016.

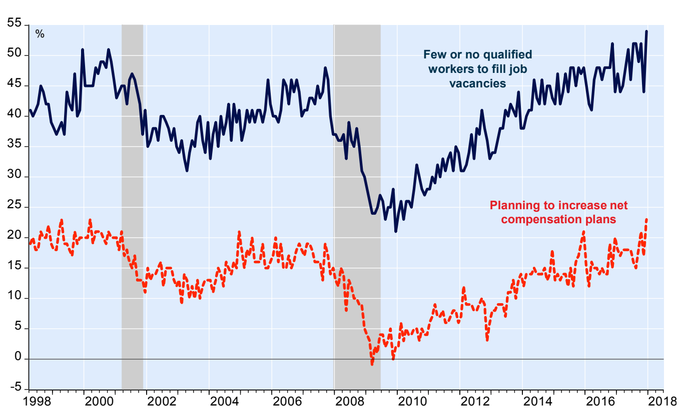
Canada: Earnings revision are turning positive in energy sector
1-month change in 12-month forward earnings for the S&P/TSX Energy



NBF Economics and Strategy (data via Datastream)

Though our outlook for the Canadian economy in 2018 remains upbeat, we recognize two main uncertainties: NAFTA and consumer debt. NAFTA 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. According to the National Federation of Independent Businesses, no less than 54% of small firms report that they find few or no qualified applicants to fill their job vacancies, the highest percentage ever recorded. We will continue to monitor the situation very closely, but at this writing our baseline scenario is still a revamped rather than a scrapped NAFTA.

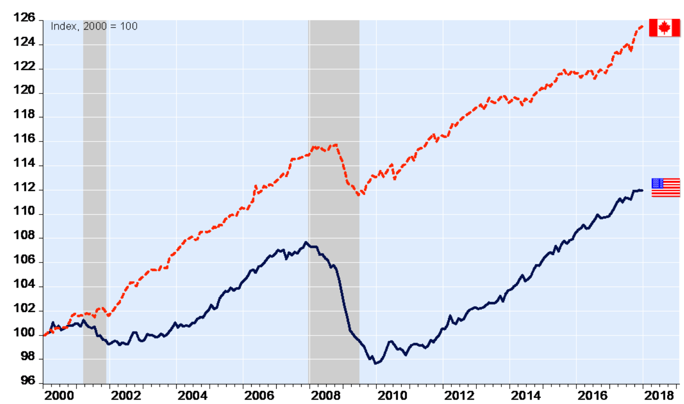
U.S.: Report shows growing shortage of qualified workers
% of firms having trouble finding qualified applicants vs. % planning to increase compensations



NBF Economics and Strategy (data via Datastream)

What about consumer debt? The surging Canadian economy has obliged the Bank of Canada to raise its policy rate three times since last summer. Have we reached the point where forced household retrenchment will crimp the credit cycle and bank earnings? We don't think so. Despite three consecutive hikes, the Bank of Canada's overnight rate remains below the inflation rate. We are very far from a restrictive monetary stance. What's more, employment growth remains very strong. The economy has added a record 254,000 full-time jobs in the last four months. This development is the key support for labour income and household formation.

Canada: Full-time employment is surging
Full-time employment: Canada vs. the U.S.

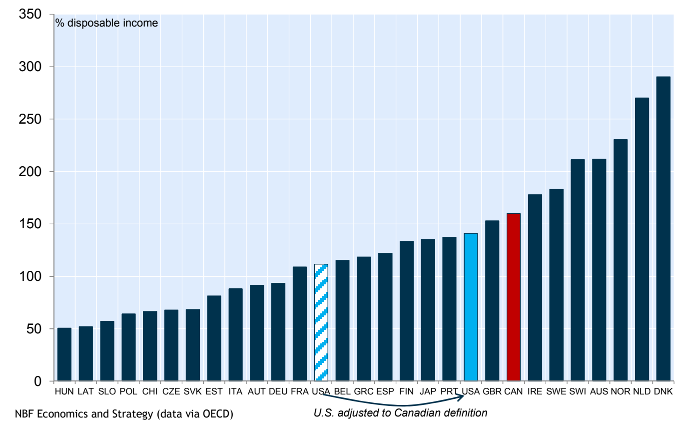


NBF Economics and Strategy (data via Datastream)

The ratio of household debt to disposable income in Canada is nevertheless still seen by some as unsustainably high and a source of vulnerability for the financial system. But the international evidence suggests that Canadian household leverage and home prices are not abnormal. Our analysis, controlling for fundamentals such as employment, population growth, housing tenure, immigration, education and the solidity of the welfare system, suggests that the ratio of household debt to disposable income in Canada is not excessive.[2] All and all, we do not think that banks are on the verge of earnings disappointments.

[2] For more details see our *Special Report: Is Canada's household leverage too high — or on the low side?*, January 2018.

Canada: Perspective on household leverage
Household debt as a percentage of net disposable income (major OECD countries)



NBF Economics and Strategy (data via OECD)

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. That said, it is important to remain on the watch for any unexpected pickup in inflationary pressures that could compromise the profit outlook by pushing the 10-year Treasury yield above the comfort zone of the economy. For the U.S. we peg this comfort zone at 3.0% to 3.2%.

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
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NBF Market Forecast *Canada*			
		Actual	***Q22018 (Est.)***
Index Level		**Jan-29-18**	***Target***
S&P/TSX		16,095	16,700
Assumptions			Q22018 (Est.)
Level:	Earnings *	910	960
	Dividend	443	467
PE Trailing (implied)		17.7	17.4
			Q22018 (Est.)
Treasury Bills (91 days)		1.21	1.68
10-year Bond Yield		2.28	2.51

** Before extraordinary items, source Thomson*

NBF Economics and Strategy

NBF Market Forecast *United States*			
		Actual	***Q22018 (Est.)***
Index Level		**Jan-29-18**	***Target***
S&P 500		2,854	2,950
Assumptions			Q22018 (Est.)
Level:	Earnings *	132	140
	Dividend	50	53
PE Trailing (implied)		21.7	21.1
			Q22018 (Est.)
Treasury Bills (91 days)		1.43	1.59
10-year Bond Yield		2.70	2.80

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

NATIONAL BANK OF CANADA FINANCIAL MARKETS

NBF Fundamental Sector Rotation - February 2018

Name (Sector/Industry)	Recommendation	S&P/TSX weight
Energy	**Overweight**	**19.2%**
Energy Equipment & Services	Overweight	0.6%
Oil, Gas & Consumable Fuels	Overweight	18.6%
Materials	**Market Weight**	**11.6%**
Chemicals	Underweight	2.3%
Containers & Packaging	Market Weight	0.6%
Metals & Mining *	Overweight	3.0%
Gold	Market Weight	5.2%
Paper & Forest Products	Overweight	0.6%
Industrials	**Market Weight**	**9.4%**
Capital Goods	Overweight	2.3%
Commercial & Professional Services	Underweight	1.7%
Transportation	Market Weight	5.5%
Consumer Discretionary	**Underweight**	**5.5%**
Automobiles & Components	Underweight	1.3%
Consumer Durables & Apparel	Overweight	0.7%
Consumer Services	Underweight	1.2%
Media	Market Weight	0.9%
Retailing	Underweight	1.4%
Consumer Staples	**Underweight**	**3.7%**
Food & Staples Retailing	Underweight	2.9%
Food, Beverage & Tobacco	Underweight	0.8%
Health Care	**Market Weight**	**1.0%**
Health Care Equipment & Services	Market Weight	0.2%
Pharmaceuticals, Biotechnology & Life Sciences	Market Weight	0.8%
Financials	**Market Weight**	**35.0%**
Banks	Market Weight	24.2%
Diversified Financials	Market Weight	3.9%
Insurance	Market Weight	6.9%
Information Technology	**Overweight**	**3.4%**
Software & Services	Overweight	3.3%
Technology Hardware & Equipment	Market Weight	0.2%
Telecommunication Services	**Underweight**	**4.5%**
Utilities	**Underweight**	**3.7%**
Real Estate	**Underweight**	**2.9%**

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

Monthly Equity Monitor

Economics and Strategy

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Monthly Equity Monitor

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