NATIONAL BANK OF CANADA
FINANCIAL MARKETS

Monthly Equity Monitor

Economics and Strategy

November 2018

Highlights

- We argued last month that the Q3 global equity rally could not easily carry into Q4. The past few weeks proved us right. The MSCI-AC index fell 7% in October, the worst performance for that month since 2008 when the global economy was in recession. As dire as the prospect suggested by this comparison might seem, it is important to remember that in 2008, global equities had fallen 30% even before the October crash. Moreover, global industrial production, despite a recent slowdown, is still expanding. A big difference from 10 years ago, when output was contracting.
- The recent upside turn of economic surprise indexes for both the U.S. and China could stabilize stock markets, especially if Washington and Beijing manage to settle some of their differences at the November 30 Buenos Aires meeting of G20 leaders.
- The Q3 U.S. earnings season turned out to be a good one, with 77% of S&P 500 companies reporting earnings per share above analyst expectations. But a good quarterly earnings season is not enough to push stock indexes higher. The equity market, ever forward-looking, has its eyes on 2019. We like the recent scaling-back of forward earnings guidance to single-digit growth for most sectors next year.
- Since June we have been arguing that equity markets were vulnerable to downward earnings revisions, since forward earnings were failing to reflect the effect of escalating trade tensions and USD appreciation in an environment of rising interest rates. After the recent market correction we find valuations more reasonable.
- In light of recent developments, we are altering our asset allocation this month. We are reducing our excess cash position by 3 percentage points in favour of emerging markets, which we move from underweight to overweight relative to our benchmark.
- Our sector allocation is also modified this month. In June we recommended a caution-inspired shift of assets to Telecoms and Utilities. These sectors have done better than the S&P TSX since this recommendation, but our conviction that they will continue to do so is much weaker with interest rates slated to rise still further. So we are shifting them from overweight to neutral, and deploying the proceeds to shift metals & mining to overweight on the assumption that global economy expands at a rate of around 3.5% in 2019.

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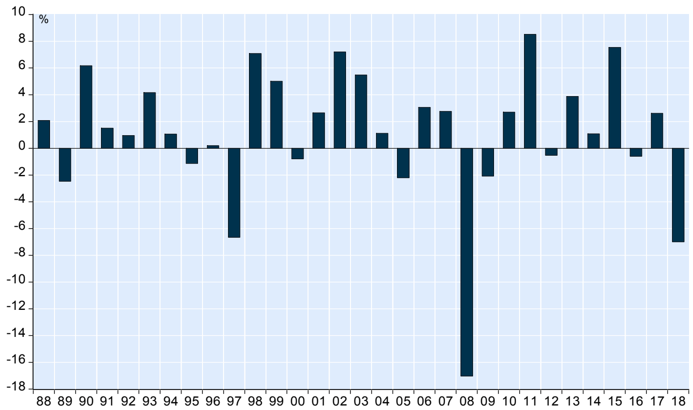
Monthly Equity Monitor

World: Red October

We argued last month that the Q3 global equity rally could not easily carry into Q4. October proved us right. The MSCI-AC index fell 7% over the month, the worst October showing since 2008 when the global economy was in recession (chart).

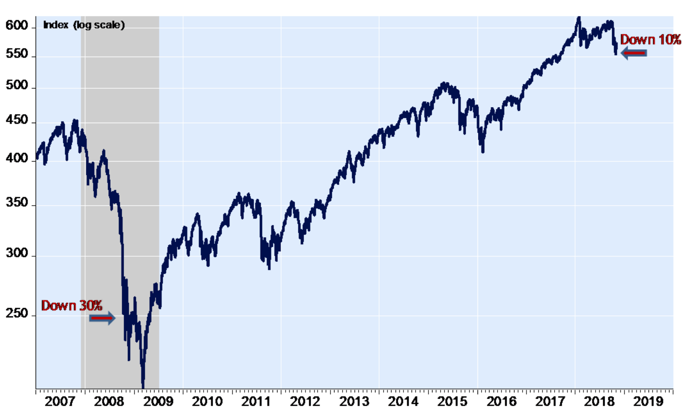
World: The worst October since 2008
Performance of MSCI AC in October of every year



NBF Economics and Strategy (data via Refinitiv)

As dire as the prospect suggested by this comparison might seem, it is important to remember that in 2008, global equities had fallen 30% even before the October crash. This time around, the cumulative pullback up to the beginning of October was only 3% (chart). In other words, the move last month was violent, but we are looking at a correction not a bear market.

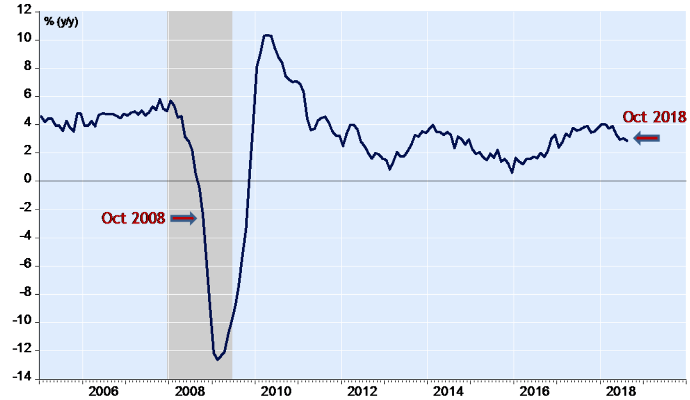
World: Let's keep things in perspective
MSCI AC



NBF Economics and Strategy (data via Refinitiv)

Moreover, global industrial production, despite a recent slowdown, is still expanding at about 3% year over year. A big difference from 10 years ago, when output was contracting (chart). Another difference is that in 2008 global credit markets had seized up after the Lehman Brothers bankruptcy filing in September of that year.

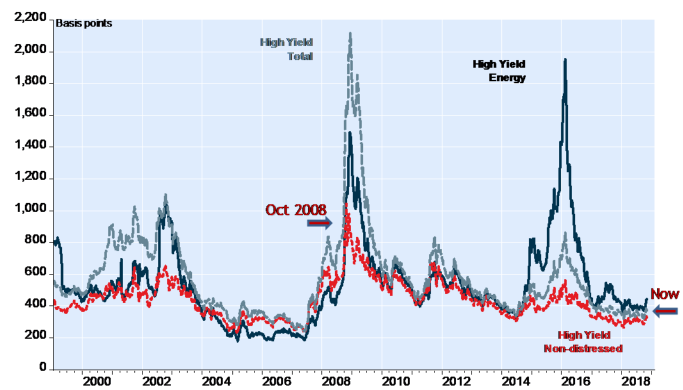
World: Let's keep things in perspective
Global industrial production



NBF Economics and Strategy (data via Refinitiv)

And as of early November, we find solace in corporate credit spreads, which have widened somewhat but are nowhere near those normally associated with economic hardship (chart).

U.S.: High-yield corporate spreads
Option adjusted spreads



NBF Economics and Strategy (Source ICE BofAML Bond Indices) 2018-11-02

However, there is one component of the global investment backdrop that is more worrisome now than a decade ago: geopolitical uncertainty. The index of global political uncertainty is nearing the multi-year peak that followed the 2016 U.S. presidential election (chart). Investors have been made skittish by U.S. mid-term elections, the Iran petroleum embargo imposed by Washington and by China-U.S. trade tension.

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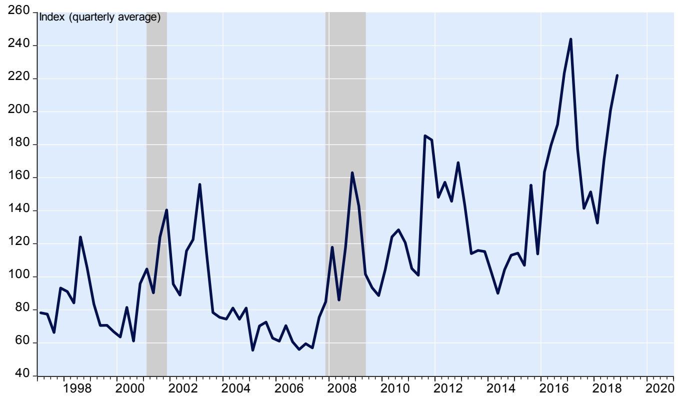
World: A stressful environment
Index of global political uncertainty



NBF Economics and Strategy (data via http://www.policyuncertainty.com/global_monthly.html)

We wrote last month that with economic growth set to slow in Q4, the outlook for equity markets will depend on action by policymakers to reaccelerate it in 2019. For most markets, including the U.S., earnings growth expectations for calendar 2019 are now down to single digits (table).

MSCI composite index: EPS Performance

	2017	2018	2019	2020	12 months forward
MSCI AC World	17.2	15.8	9.3	9.3	9.6
MSCI World	16.3	16.1	8.9	9.0	9.4
MSCI USA	11.8	24.0	9.6	10.4	10.5
MSCI Canada	29.6	12.6	12.4	10.6	12.3
MSCI Europe	15.5	7.6	9.4	7.9	9.2
MSCI Pacific ex Jp	16.4	9.2	7.1	5.5	7.2
MSCI Japan	NA	38.7	3.8	3.7	3.7
MSCI EM	22.2	13.6	11.2	11.2	11.0
MSCI EM EMEA	12.3	18.8	10.0	9.9	10.0
MSCI EM Latin America	19.6	16.1	20.2	8.3	19.9
MSCI EM Asia	25.1	12.1	10.1	12.0	10.0

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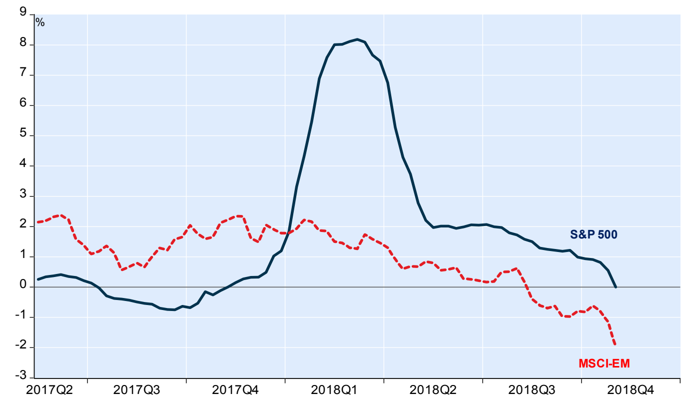
NBF Economics and Strategy (data via Datastream)

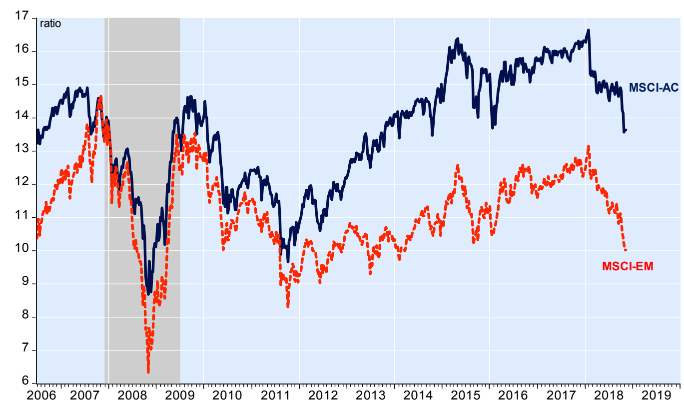
Expectations could of course fall further, especially if the China-U.S. trade feud worsens. It should be kept in mind, however, that much bad news is already reflected in the markets, especially in emerging markets, where forward P/Es have fallen below 10 for the first time in nearly five years.

World: Will earnings revisions stay negative?
3-month change in twelve-month forward EPS: MSCI-EM vs. S&P 500



NBF Economics and Strategy (data via Refinitiv)

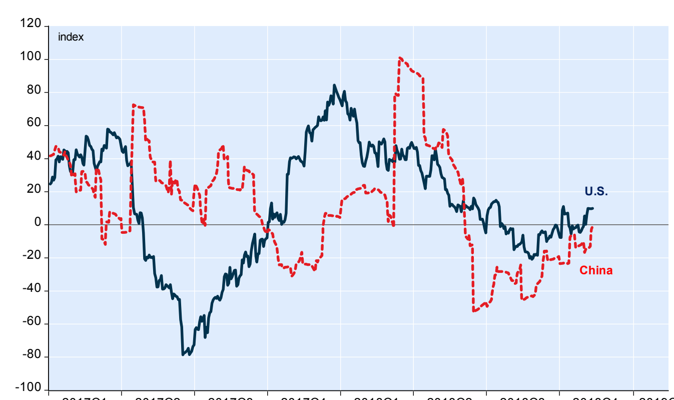
World: Perspective on valuations
Forward PE ratio for the MSCI-AC and MSCI-EM



NBF Economics and Strategy (data via Refinitiv)

The recent upside turn of economic surprise indexes for both the U.S. and China could stabilize stock markets, especially if Washington and Beijing manage to settle some of their differences at the November 30 Buenos Aires meeting of G20 leaders.

World: Positive economic surprises in two biggest economies
Citi economic surprise index – China and the U.S.

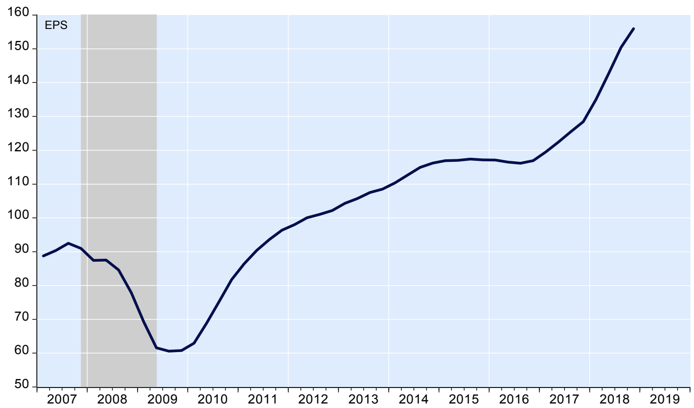


NBF Economics and Strategy (data via Bloomberg)

U.S.: Earnings expectations

The Q3 U.S. earnings season turned out to be a good one, with 77% of S&P 500 companies reporting earnings per share above analyst expectations. The beat factor was quite impressive — reported earnings 6.5% above estimates versus the historical average of 3.2% reported by Refinitiv. The result was a record in quarterly earnings per share.

U.S.: Earnings at a record high in Q3
Trailing EPS of the S&P 500

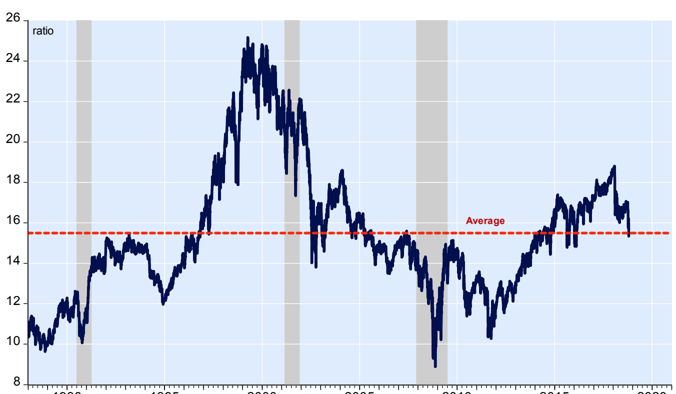


NBF Economics and Strategy (data via Refinitiv)

But a good quarterly earnings season is not enough to push stock indexes higher. Where will they go from here?

As we have said time and again, P/E expansion is not the norm in this mature phase of the business cycle. Case in point, U.S. P/E ratios peaked last January after corporate tax cuts were enacted and have been coming down ever since (chart). The equity market, ever forward-looking, has its eyes on 2019.

U.S.: Perspective on valuation
Forward PE for the S&P 500



NBF Economics and Strategy (data via Refinitiv)

We like the recent scaling-back of forward earnings guidance to single-digit growth for most sectors in 2019.

S&P 500 composite index: EPS Performance

	2017	2018	2019	2020	12 months forward
S&P 500	11.8	23.6	9.4	10.3	10.3
ENERGY	357.9	94.4	29.9	11.5	32.8
MATERIALS	14.6	27.1	6.5	11.8	7.7
INDUSTRIALS	4.7	19.6	11.3	11.9	11.7
CONS. DISC.	6.1	18.8	10.4	13.5	11.1
CONS. STAP.	6.3	10.8	5.2	7.3	5.6
HEALTH CARE	8.2	15.7	7.3	9.0	7.9
FINANCIALS	7.0	31.8	9.4	9.8	10.8
IT	20.5	25.7	8.3	10.4	9.2
TELECOM	5.7	21.1	7.0	10.7	7.9
UTILITIES	2.8	7.0	5.2	5.3	5.3
REAL ESTATE	-10.9	-8.4	-3.6	9.3	-4.0

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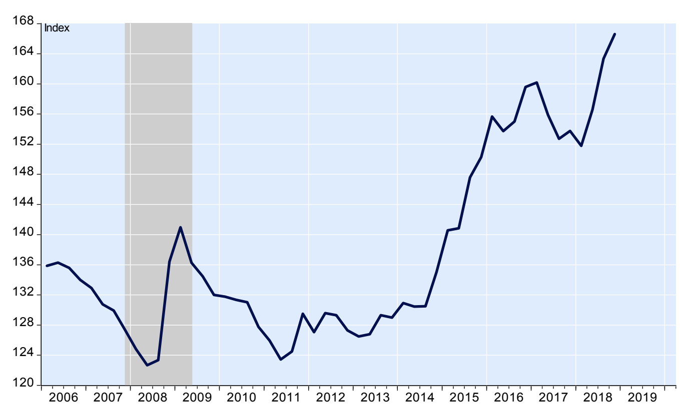
NBF Economics and Strategy (data via Datastream)

And while just a few weeks ago more than half the forecast earnings growth was expected to come from margin expansion and stock buybacks, this is no longer the case. At this writing, about 60% of earnings growth is expected to come from revenues — a much more reasonable assumption in an environment of higher interest rates, rising labour costs and a stronger currency. The Federal Reserve reports that the greenback recently surged to yet another record high against a basket of 19 emerging-market currencies. An abatement of trade tensions could go far to weaken the USD, support global economic expansion and forestall compression of profit margins.

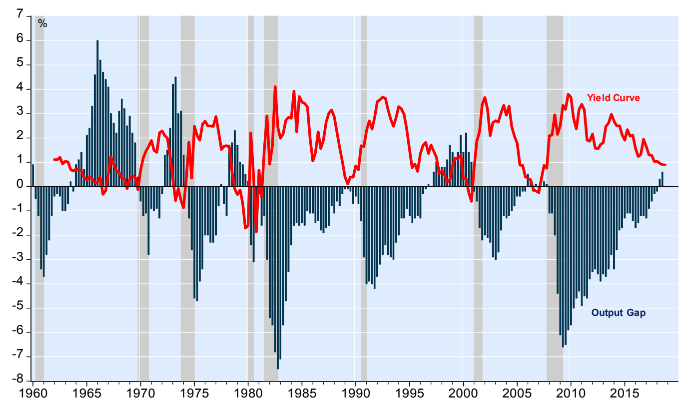
U.S.: The greenback at record strength vs. emerging-market currencies
The USD against a basket of 19 emerging-market currencies



NBF Economics and Strategy (data via Datastream)

So far, the Federal Reserve has seen the recent weakness of equity markets as a normal adjustment to higher long rates, which mean a higher discount rate for expected corporate earnings. Though the U.S. labour market remains vibrant — the jobless rate of 3.7% is the lowest in nearly 50 years — we were encouraged to see the November FOMC meeting maintain the Fed's commitment to gradual normalization of monetary policy. The Fed should not underestimate the sensitivity of the economy to higher interest rates at this point in the cycle. The recent weakness of residential markets (new-home sales, starts, resales) is a strong exhibit in the argument for the Fed to stick with a go-slow approach at this point. The yield curve, even after continued flattening, remains relatively steep for this point in the cycle, i.e. relative to the positive output gap (chart).

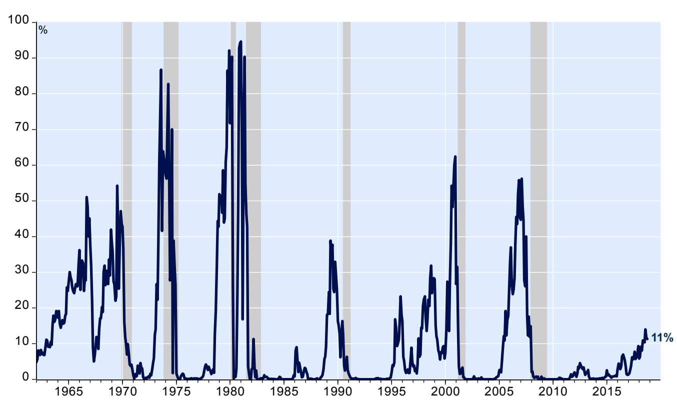
U.S.: Yield curve not that flat at this point in the cycle
Output gap* vs. yield curve (10-year Treasury yield less 3-month T Bill)



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

On the basis of the current U.S. yield-curve slope, we put the chances of a U.S. recession over the next 12 to 18 months at less than 15% (charts).

U.S.: Recession probability is low
Probability of recession based on the slope of the yield curve



NBF Economics and Strategy (data via Datastream) 10 year yield – 3 month yield

Canada: Can the S&P/TSX rebound?

The S&P/TSX struggled in Q3 and continues to do so in Q4. At this writing the Canadian benchmark is down 5% quarter to date, with only the defensive sectors (Staples, Utilities, Telcos) showing gains (chart).

S&P/TSX composite index: Price Performance

	Month to date	Quarter to date	Year to date
S&P TSX	1.6	-5.0	-5.8
HEALTH CARE	8.7	-10.5	15.6
CONS. STAP.	3.9	3.1	-1.6
UTILITIES	3.6	0.7	-10.5
TELECOM	3.0	0.8	-5.3
CONS. DISC.	2.1	-4.4	-10.4
REAL ESTATE	1.7	-1.7	3.7
ENERGY	1.6	-7.7	-11.4
MATERIALS	1.3	-3.3	-13.9
FINANCIALS	1.3	-5.7	-6.0
INDUSTRIALS	0.5	-5.4	5.3
BANKS	0.4	-6.9	-5.5
IT	-0.4	-8.5	14.9

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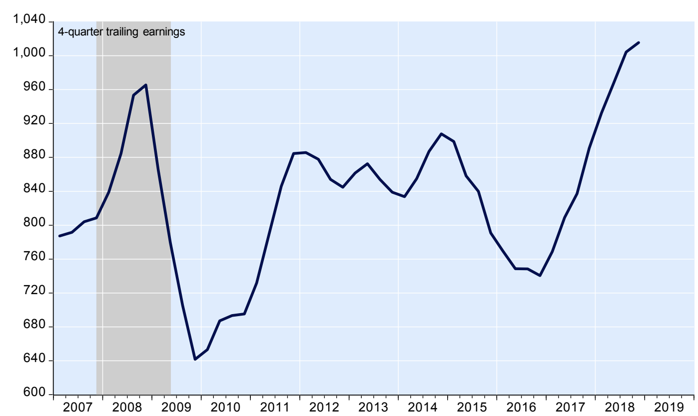
NBF Economics and Strategy (data via Datastream)

As has been the case all year, the doldrums of the S&P/TSX are not attributable to economic weakness. The economy has been resilient — Canadian GDP continues to surprise on the upside, the labour market remains strong and S&P/TSX index earnings reached a record in Q3 (chart).

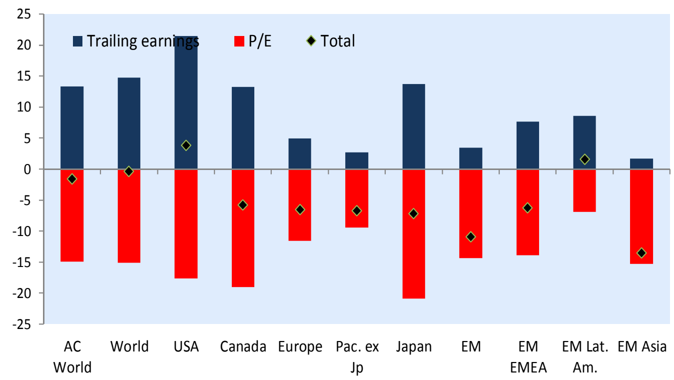
Canada: Record profits in Q3
Trailing EPS of the S&P/TSX



NBF Economics and Strategy (data via Refinitiv)

Uncertainty, both domestic and international, continues to weigh on Canadian P/Es more forcefully than on those of most other countries. Only in Japan have P/Es contracted more steeply than in Canada over 2018 to date.

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



NBF Economics and Strategy (data via Datastream)

The U.S. mid-term elections returned control of the House to Democrats and left Republicans in control of the Senate. This outcome has raised concern about ratification of the recently revamped trade deal, the United States-Mexico-Canada Agreement or USMCA for short. Though a split Congress is not an obstacle to ratification of USMCA, the vote might be postponed well into 2019. In these circumstances, Ottawa would be well-advised to provide support in its November 21 fiscal update for P/Es and investment in key industries that have been trading at a substantial discount to their historical average.

But at the end of the day, a sustained rally of the S&P/TSX is hard to imagine without a firming of commodity prices. Oil prices have recently given back all of their gains for 2018, with the WCS price back virtually to the lows of 2017. Metals and lumber have also been weakening as of late. If we are right that global economic expansion will continue in 2019, the current expectations for commodity prices in the coming year (table) may be exceeded.

World: Commodity prices expectations

Analyst Assumptions

	Copper	Gold	Crude Oil	Natural Gas
Current Price	6056	1210	60	3.72
Analyst assumptions				
Q+2	6800	1270	69	2.94
Q+4	6783	1275	69	3.00
Growth (Q_t/Q_0)				
Q+2	12.3%	5.0%	14.6%	-20.9%
Q+4	12.0%	5.4%	13.8%	-19.3%
Current Forward Prices				
	Copper	Gold	Crude Oil	Natural Gas
Current Price	6056	1210	60	3.72
Forward prices				
Q+2	6146	1241	62	2.74
Q+4	6149	1260	63	2.95
Growth (Q_t/Q_0)				
Q+2	1.5%	2.6%	3.1%	-26.3%
Q+4	1.5%	4.2%	3.9%	-20.7%

11/10/2018

NBF Economics and Strategy (data via Datastream)

Asset allocation

Since June we have been arguing that equity markets were vulnerable to downward earnings revisions, since forward earnings were failing to reflect the effect of escalating trade tensions and USD appreciation in an environment of rising interest rates. After the recent market correction we find valuations more plausible, given our view that global GDP will grow about 3.5% in 2019. In light of recent developments, we are altering our asset allocation this month.

We are reducing our excess cash position by 3 percentage points in favour of emerging markets, which we move from underweight to overweight relative to our benchmark. Though we still see the Federal Reserve hiking again in December, we expect it to normalize its policy rate much more gradually in 2019. This should alleviate some of the stress on emerging markets by paving the way for USD depreciation. As noted in our November *Economic Monitor*, we also expect a dose of fiscal and monetary stimulus from China in the coming months. Note that even after our asset mix change, the cash position remains above benchmark. We remain ready to redeploy more of the excess cash as opportunities arise.

Sector rotation

Our sector allocation is also modified this month. In June we recommended a caution-inspired shift of assets to Telecoms and Utilities. These sectors have done better than the S&P TSX since this recommendation, but our conviction that they will continue to do so is much weaker with interest rates slated to rise still further. So we are shifting them from overweight to neutral, and deploying the proceeds to shift metals & mining to overweight.

Monthly Equity Monitor

NATIONAL BANK OF CANADA FINANCIAL MARKETS

NBF Asset Allocation	Benchmark (%)	NBF Recommendation (%)	Change (pp)
Equities			
Canadian Equities	20	24	
U.S. Equities	20	16	
Foreign Equities (EAFE)	5	8	
Emerging markets	5	6	+3
Fixed Income	45	39	
Cash	5	7	-3
Total	100	100	

NBF Economics and Strategy

NBF Market Forecast *Canada*			
		Actual	***Q42019(Est.)***
Index Level		**Nov-09-18**	***Target***
S&P/TSX		15,274	16,600
Assumptions			Q42019(Est.)
Level:	Earnings *	1024	1100
	Dividend	483	518
PE Trailing (implied)		14.9	15.1
			Q42019(Est.)
10-year Bond Yield		2.51	3.10

** Before extraordinary items, source Thomson*

NBF Economics and Strategy

NBF Market Forecast *United States*			
		Actual	***Q42019(Est.)***
Index Level		**Nov-09-18**	***Target***
S&P 500		2,781	2,970
Assumptions			Q42019(Est.)
Level:	Earnings *	158	173
	Dividend	53	59
PE Trailing (implied)		17.6	17.2
			Q42019(Est.)
10-year Bond Yield		3.19	3.50

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

NBF Fundamental Sector Rotation - November 2018

Name (Sector/Industry)	Recommendation	S&P/TSX weight
Energy	**Overweight**	**18.6%**
Energy Equipment & Services	Overweight	0.5%
Oil, Gas & Consumable Fuels	Overweight	18.0%
Materials	**Overweight**	**10.3%**
Chemicals	Market Weight	2.5%
Containers & Packaging	Market Weight	0.5%
Metals & Mining *	Overweight	2.4%
Gold	Overweight	4.4%
Paper & Forest Products	Market Weight	0.5%
Industrials	**Underweight**	**10.6%**
Capital Goods	Market Weight	2.2%
Commercial & Professional Services	Underweight	1.9%
Transportation	Underweight	6.5%
Consumer Discretionary	**Underweight**	**4.3%**
Automobiles & Components	Underweight	1.1%
Consumer Durables & Apparel	Overweight	0.8%
Consumer Services	Underweight	1.3%
Retailing	Underweight	1.1%
Consumer Staples	**Overweight**	**3.7%**
Food & Staples Retailing	Overweight	2.9%
Food, Beverage & Tobacco	Overweight	0.8%
Health Care	**Underweight**	**1.9%**
Health Care Equipment & Services	Underweight	0.2%
Pharmaceuticals, Biotechnology & Life Sciences	Underweight	1.6%
Financials	**Market Weight**	**33.9%**
Banks	Market Weight	23.5%
Diversified Financials	Market Weight	4.0%
Insurance	Market Weight	6.4%
Information Technology	**Underweight**	**3.9%**
Software & Services	Underweight	3.7%
Technology Hardware & Equipment	Underweight	0.2%
Telecommunication Services	**Market Weight**	**5.6%**
Utilities	**Market Weight**	**4.0%**
Real Estate	**Market Weight**	**3.2%**

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

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Monthly Equity Monitor

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