NATIONAL BANK OF CANADA
FINANCIAL MARKETS

Monthly Equity Monitor

Economics and Strategy

October 2017

Highlights

- The global economic expansion remains on track after a first half in which industrial output grew at the fastest pace in six years. The string of improving economic indicators has boosted investor confidence, which explains in part why the MSCI All Country index is at an all-time high. Crucially, this global benchmark continues to be lifted by earnings growth rather than by P/E expansion.
- This has been a very long rally for the S&P 500 — 318 days and counting without a correction of 5% or more, the fourth-longest such run since 1960. Yet we do not foresee a severe or extended pullback. The equity risk premium, i.e. the spread between the return on investment in the stock market and the return on a risk-free (Treasury bond) investment, remains attractive by historical standards
- After treading water for most of the year, the S&P/TSX is making a comeback. In September the Canadian benchmark surged 2.8%, its best monthly gain in 14 months, and it now shows a positive return of 2.3% for the year. Interestingly, S&P/TSX earnings revisions have turned positive in the past month, a turn that contrasts with slightly downward revisions for the U.S. S&P 500. We see further upside for the S&P/TSX ahead. Our year end target is 16,100.
- 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.
- Our sector allocation is unchanged this month. We remain overweight in Financials as this sector is set to benefit from higher interest rates in a strong economy. We remain market-weighted in Energy and underweight in Telecoms, Utilities and Consumer Staples as these sectors are especially vulnerable to rising interest rates.

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Earnings on the rise

The global economic expansion remains on track after a first half in which industrial output grew at the fastest pace in six years. World trade volume is close to a record, and so is employment in major economies. The string of improving indicators has boosted investor confidence, which explains in part why the MSCI All Country index is at an all-time high. On a total-return basis it is now up 14.2% year to date, with positive contributions from all the major regions of the world (table).

MSCI composite index: Price Performance (Total return)

	Month to date	Quarter to date	Year to date
MSCI AC World	2.1	4.5	14.2
MSCI World	2.4	4.1	13.0
MSCI USA	2.0	4.5	14.4
MSCI Canada	3.5	4.1	4.4
MSCI Europe	2.7	3.5	12.2
MSCI Pacific ex Jp	-0.3	2.2	11.6
MSCI Japan	4.4	4.3	10.6
MSCI EM	0.5	7.7	23.9
MSCI EM EMEA	-1.9	6.9	7.9
MSCI EM Latin America	2.6	11.8	20.1
MSCI EM Asia	0.6	7.2	28.5

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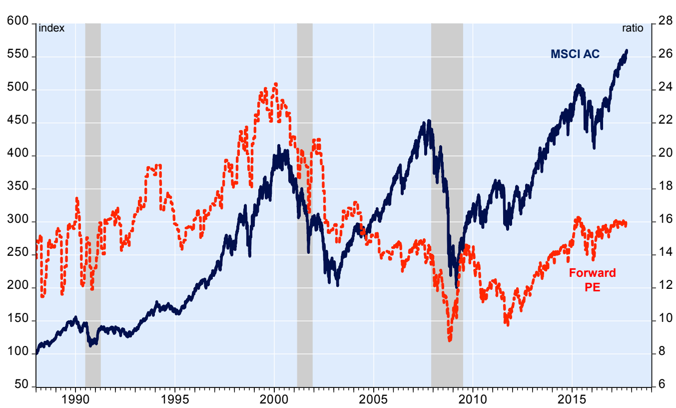
NBF Economics and Strategy (data via Datastream)

Crucially, this global benchmark continues to be lifted by earnings growth rather than by P/E expansion. At 16 times forward earnings, the 12-month-forward P/E for the MSCI AC is in fact near its historical average.

World: Record level with a stable PE
MSCI AC and its 12-month forward PE



NBF Economics and Strategy (data via Datastream)

The bottom-up consensus of equity analysts expects that MSCI AC earnings, spurred by the most synchronous global economic growth in more than a decade, will grow 10.9% in the next 12 months (table), topping 30 for the first time in more than a decade (chart).

MSCI composite index: EPS Performance

	2016	2017	2018	2019	12 months forward
MSCI AC World	3.1	13.6	9.9	9.7	10.9
MSCI World	2.4	12.4	9.6	9.4	10.4
MSCI USA	2.2	10.4	11.5	10.3	11.4
MSCI Canada	-4.6	25.1	8.3	10.6	11.4
MSCI Europe	1.4	12.7	8.4	8.5	9.1
MSCI Pacific ex Jp	-7.8	16.3	4.8	5.8	5.7
MSCI Japan	NA	15.9	15.8	5.7	10.2
MSCI EM	7.7	21.3	12.1	11.5	14.1
MSCI EM EMEA	6.4	11.2	14.0	9.2	13.9
MSCI EM Latin America	54.2	20.8	9.1	17.6	11.8
MSCI EM Asia	2.9	23.9	12.1	11.1	14.5

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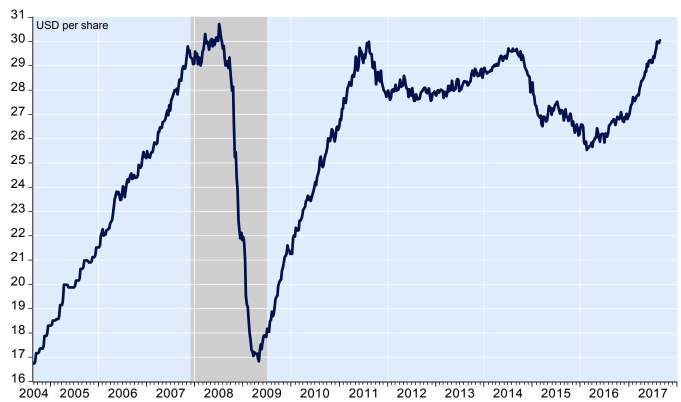
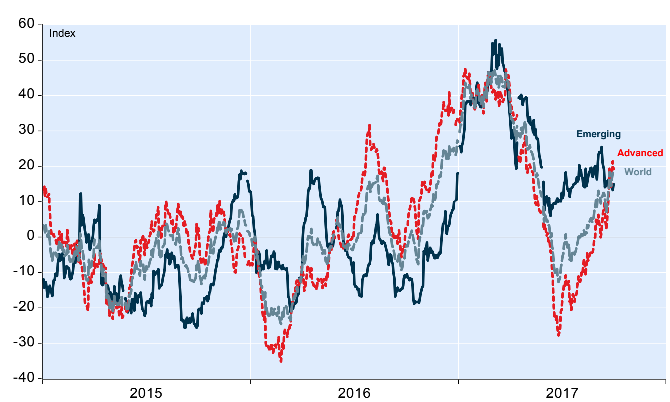
World: Earnings expected to hit a record
Estimated 12-month-forward earnings per share for the MSCI AC



NBF Economics and Strategy (data via Datastream)

This outlook is supported by accommodative monetary and fiscal policy and by narrow corporate bond spreads across the mature economies. For the time being, a favourable cyclical backdrop continues to trump geopolitical fears as economic indicators surprise on the upside (chart).

World: Positive economic surprises
Citi economic surprise index for World, Advanced and Emerging markets



NBF Economics and Strategy (data via Bloomberg)

U.S.: Can this rally last?

The S&P 500 ended Q3 at a new all-time high. Industrials, Materials, Technology, Health Care and Utilities all reached new highs in September. Nine months into 2017, the U.S. benchmark is up 14.2% on a total-return basis, with all sectors but Telecoms and Energy up on the year (table).

S&P 500 composite index: Price Performance (Total return)

	Month to date	Quarter to date	Year to date
S&P 500	2.1	4.5	14.2
ENERGY	9.9	6.8	-6.6
FINANCIALS	5.1	5.2	12.5
INDUSTRIALS	4.0	4.2	14.1
MATERIALS	3.5	6.0	15.8
TELECOM	3.5	6.8	-4.7
HEALTH CARE	1.0	3.7	20.3
CONS. DISC.	0.8	0.8	11.9
IT	0.6	8.6	27.4
CONS. STAP.	-0.9	-1.3	6.6
REAL ESTATE	-1.4	0.9	7.4
UTILITIES	-2.7	2.9	11.9

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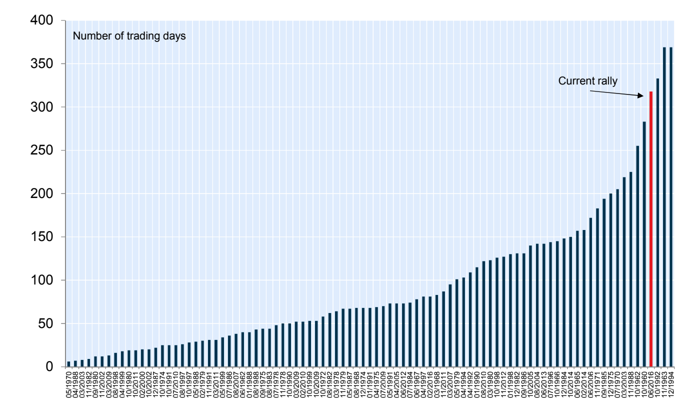
NBF Economics and Strategy (data via Datastream)

This has been a very long rally for the S&P 500 — 318 days and counting without a correction of 5% or more, the fourth-longest such run since 1960. As the chart below shows, the only longer rallies were those beginning in October 1992 (333 days), November 1963 (369 days) and December 1994 (369 days).

S&P 500: Can the rally continue without a correction?
Rallies since 1960 without a 5%+ correction



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With the S&P 500 now trading at 18 times forward earnings, the odds of a correction have certainly increased. Yet we do not foresee a severe or extended pullback. Though economic growth may have been softened a bit in the third quarter by hurricane disruptions, the U.S. did not sustain long-term damage to its industrial plant. Economic growth should thus bounce back fairly quickly, as we have seen with the beginning of reconstruction.

S&P 500 composite index: Valuation metrics (PE)

	9/29/2017	A year ago	10 year ave.	5 year average
S&P 500	18.0	17.0	14.3	15.8
ENERGY	29.0	36.9	17.1	22.9
MATERIALS	18.2	16.6	15.1	15.9
INDUSTRIALS	18.2	16.6	14.6	15.8
CONS. DISC.	19.4	17.8	16.6	17.7
CONS. STAP.	19.2	20.0	16.4	18.5
HEALTH CARE	16.6	15.2	13.7	15.7
FINANCIALS	14.2	12.1	12.6	13.2
IT	18.4	17.0	14.6	15.2
TELECOM	13.2	13.7	14.3	14.1
UTILITIES	17.7	17.7	14.6	16.2
REAL ESTATE	38.3	37.3	NA	NA

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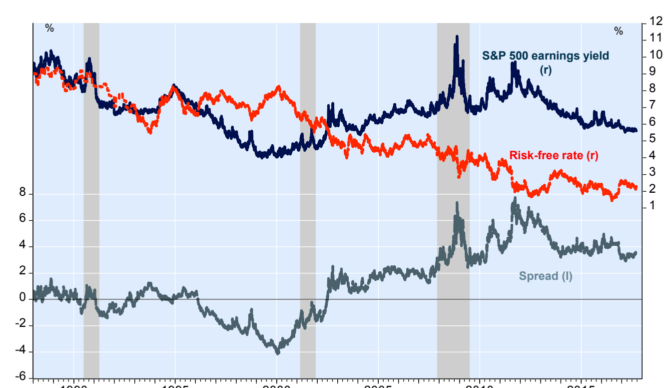
Also, the earnings outlook may get a boost from Washington via the proposed cut in the basic corporate tax rate (from 35% to 20%) and a one-time repatriation tax holiday to encourage U.S. multinationals to bring home funds held overseas. The Trump administration also intends to provide tax relief to the middle class to spur economic growth, a development that could lift earnings even higher. So for now, the U.S. stock market seems to be enjoying some continuing tailwinds. Though normalization of monetary policy is an element of risk, there is some way to go before it reaches a point that could be called restrictive.

Since inflation is still quite low, the yield of long-term Treasuries continues to rise at a slow pace. The equity risk premium, i.e. the spread between the return on investment in the stock market and the return on a risk-free (Treasury bond) investment, remains attractive by historical standards (chart).

U.S.: Perspective on valuation
S&P 500 earnings yield and treasuries 10-15 year yield (BofA ML)



NBF Economics and Strategy (data via Datastream)

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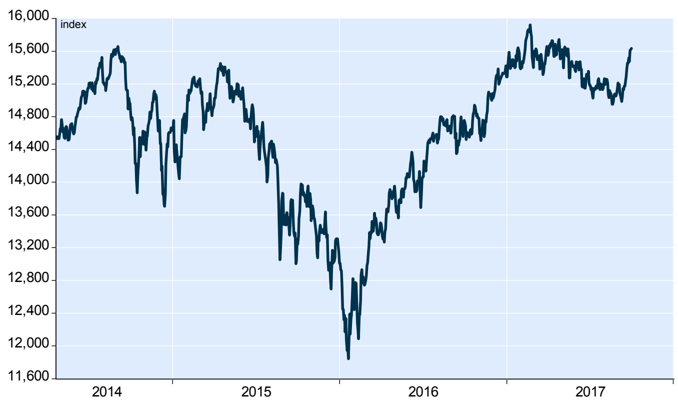
Canada: An S&P/TSX rebound!

After treading water for most of the year, the S&P/TSX is making a comeback. In September the Canadian benchmark surged 2.8%, its best monthly gain in 14 months, and it now shows a positive return of 2.3% for the year to date (table).

S&P/TSX: The index stages a comeback in September
S&P/TSX



NBF Economics and Strategy (data via Datastream)

Large rebounds in Energy (+7.4%) and banks (+4.4%) more than offset declines in defensive segments such as telcos, real estate, utilities and staples. Gold stocks were also down in September, a 6.9% retreat that was the largest monthly decline since last November.

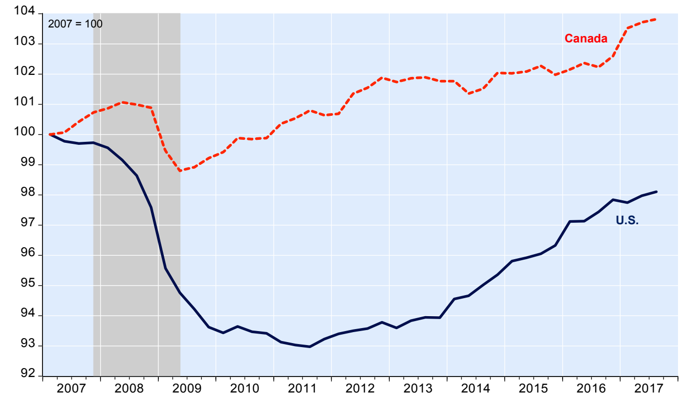
S&P/TSX composite index: Price Performance

	Month to date	Quarter to date	Year to date
S&P TSX	2.8	3.0	2.3
ENERGY	7.4	5.7	-9.9
CONS. DISC.	5.5	4.2	15.7
HEALTH CARE	5.2	-10.5	-9.3
BANKS	4.4	3.9	4.6
FINANCIALS	3.8	3.7	4.5
INDUSTRIALS	3.4	2.3	13.4
IT	2.8	3.1	12.5
CONS. STAP.	-0.3	-3.1	0.5
REAL ESTATE	-1.1	-2.2	1.0
TELECOM	-1.3	1.2	6.6
UTILITIES	-2.3	-2.9	4.6
MATERIALS	-4.0	2.9	1.6

9/29/2017
NBF Economics and Strategy (data via Datastream)

We see further upside for the S&P/TSX ahead. Our year end target is 16,100. The Canadian economy continues to grow fairly briskly, with strong employment growth for people aged 25-54, the key source of support for household formation and spending. In the U.S., employment for this age group remains below its pre-recession peak (chart).

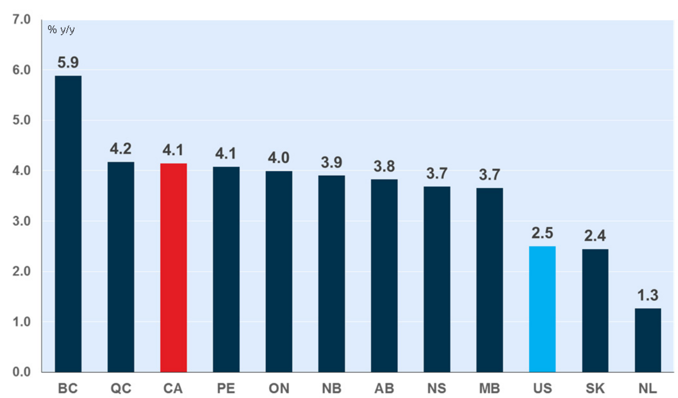
Canada: Robust job creation for prime-age workers
Total employment for people aged 25-54 (quarterly data)



NBF Economics and Strategy (data via Datastream)

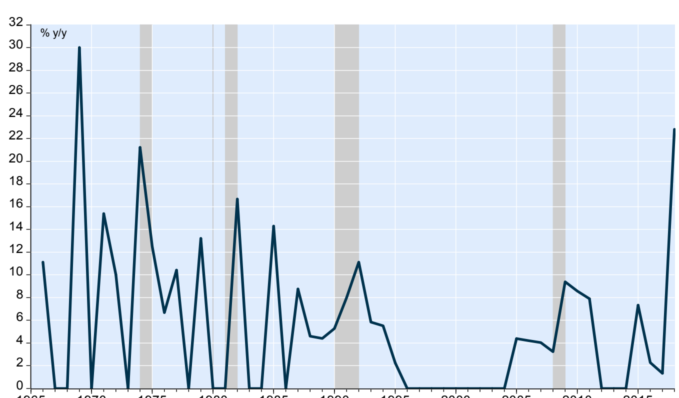
As we noted last month, Canadian wages and salaries are growing at a robust 4.1% clip, vs. 2.5% in the United States. This pace, coupled with pre-election spending in several provinces and, coming this January, Ontario's largest minimum wage increase in 50 years (to $14 an hour) could further boost demand in the short term.

Comparative growth of wages and salaries
June 2017 over June 2016



NBF Economics and Strategy (data via Statistics Canada)

Ontario: Change in minimum wage since 1965
As of January each year



NBF Economics and Strategy (data via Government of Canada)

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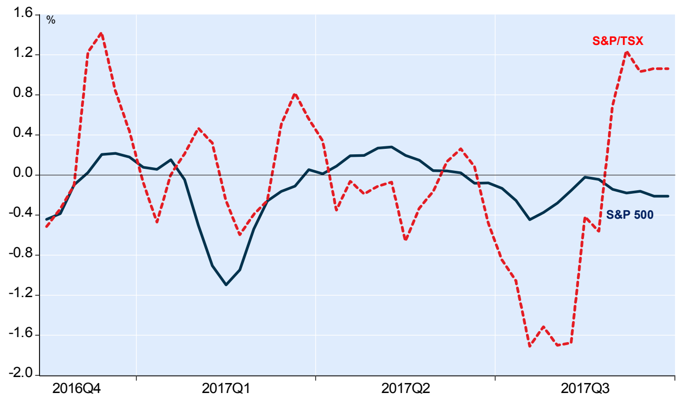
Interestingly, S&P/TSX earnings revisions have turned positive in the past month, a turn that contrasts with slightly downward revisions for the U.S. S&P 500 (chart).

S&P/TSX: Earnings revisions have turned positive
One-month change in 12-month forward earnings



NBF Economics and Strategy (data via Datastream)

Importantly, the upward revisions in Canada are relatively widespread, with seven of the 11 main S&P/TSX sectors showing improved 12-month-forward earnings (table).

Canada : change in 12-month forward earnings

	1-month change	3-month change	10 year historical average	3 month diffusion	10 year historical average
S&P TSX	1.1	-1.0	-0.9	50%	42%
ENERGY	-1.4	-19.7	-3.1	27%	40%
MATERIALS	1.9	-2.1	-2.1	61%	41%
INDUSTRIALS	0.3	3.9	-0.6	71%	41%
CONS. DISC.	0.2	0.9	-0.6	31%	45%
CONS. STAP.	1.0	-0.5	-0.1	71%	47%
HEALTH CARE	-2.9	-9.6	-0.6	0%	44%
FINANCIALS	2.2	4.3	-0.4	81%	44%
BANKS	1.3	1.4	-0.2	90%	44%
IT	0.0	0.7	-0.9	63%	50%
TELECOM	0.0	0.5	-0.1	33%	44%
UTILITIES	0.6	0.1	-0.6	27%	42%
REAL ESTATE	0.1	0.9	NA	100%	NA

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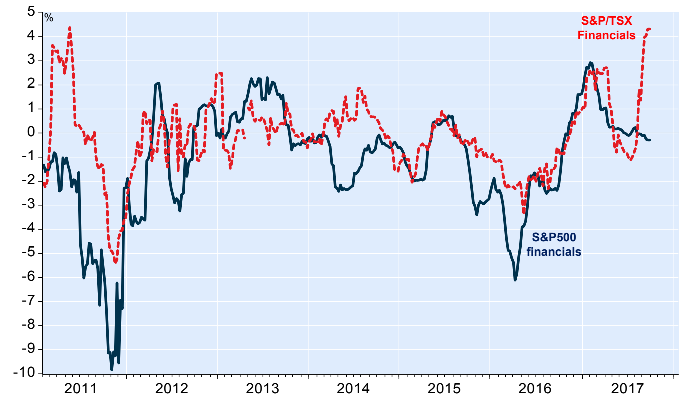
NBF Economics and Strategy (data via Datastream)

Financials are leading the charge. Their upward revisions are the best in six years (chart).

S&P/TSX: Best revisions since 2011 for financials
3-month change in 12-month forward earnings estimates



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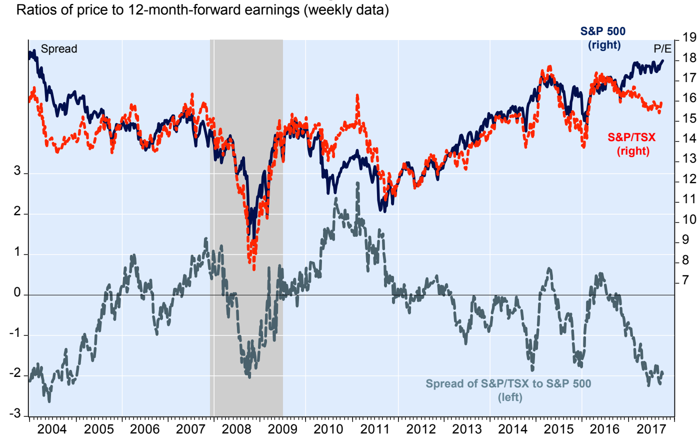
Meanwhile, the outlook for Energy profits has been much improved by the recent rebound of oil prices. With WTI now hovering just above $50 a barrel, there is less scope for downward earnings revisions.

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. Geographically, we continue to prefer Canada to the U.S. because of the valuation gap. The S&P/TSX is currently trading at a significant discount to the S&P 500.

Canada: S&P/TSX remains cheap relative to S&P 500
Ratios of price to 12-month-forward earnings (weekly data)



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Sector rotation

Our sector allocation is unchanged this month. We remain overweight in Financials as this sector is set to benefit

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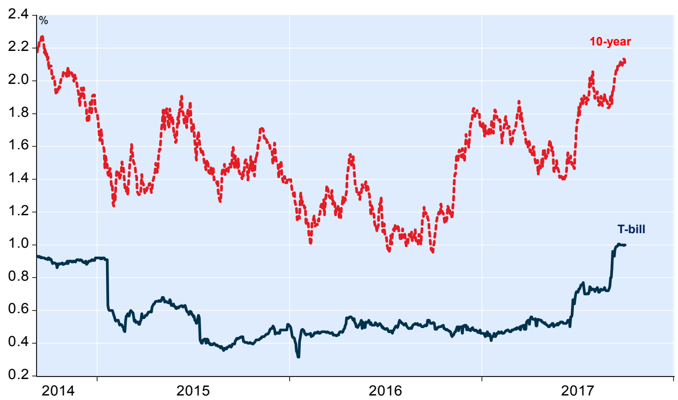
from higher interest rates in a strong economy. We remain market-weighted in Energy and underweight in Telecoms, Utilities and Consumer Staples. As we noted in last month's *Equity Monitor*, these sectors are especially vulnerable to rising interest rates (charts). We see further upside for both short- and long-term interest rates in the coming months (see our *Fixed Income Monitor* for more details).

Canada: Interest rates are on the rise
Yield on 3-month T-bill and 10-year treasury



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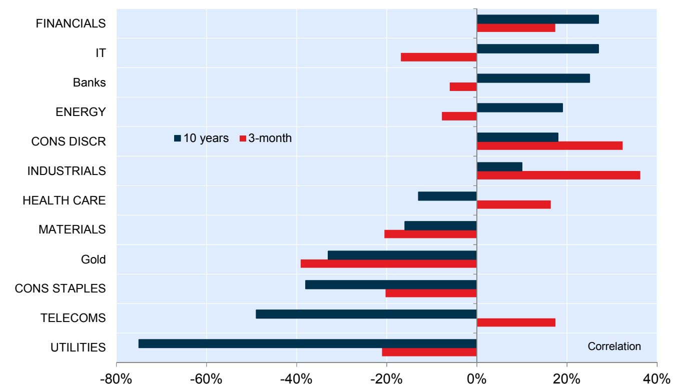
S&P TSX: Rising rates brake defensive sectors
Ten-year correlation of sector relative performance with yield of 3-month and 10-year Canadas



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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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NBF Market Forecast *Canada*			
		Actual	***Q42017 (Est.)***
Index Level		**Sep-29-17**	***Target***
S&P/TSX		15,635	16,100
Assumptions			Q42017 (Est.)
Level:	Earnings *	856	875
	Dividend	436	446
PE Trailing (implied)		18.3	18.4
			Q42017 (Est.)
Treasury Bills (91 days)		0.99	1.21
10-year Bond Yield		2.10	2.39

** Before extraordinary items, source Thomson*

NBF Economics and Strategy

NBF Market Forecast *United States*			
		Actual	***Q42017 (Est.)***
Index Level		**Sep-29-17**	***Target***
S&P 500		2,519	2,500
Assumptions			Q42017 (Est.)
Level:	Earnings *	126	130
	Dividend	48	50
PE Trailing (implied)		20.0	19.2
			Q42017 (Est.)
Treasury Bills (91 days)		1.04	1.36
10-year Bond Yield		2.33	2.50

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

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NBF Fundamental Sector Rotation - October 2017

Name (Sector/Industry)	Recommendation	S&P/TSX weight
Energy	**Market Weight**	**20.4%**
Energy Equipment & Services	Market Weight	0.6%
Oil, Gas & Consumable Fuels	Market Weight	19.7%
Materials	**Market Weight**	**11.5%**
Chemicals	Underweight	2.1%
Containers & Packaging	Market Weight	0.6%
Metals & Mining *	Market Weight	8.2%
Gold	Market Weight	5.5%
Paper & Forest Products	Overweight	0.6%
Industrials	**Market Weight**	**9.5%**
Capital Goods	Overweight	2.0%
Commercial & Professional Services	Underweight	1.7%
Transportation	Market Weight	5.8%
Consumer Discretionary	**Underweight**	**5.4%**
Automobiles & Components	Underweight	1.3%
Consumer Durables & Apparel	Overweight	0.6%
Consumer Services	Underweight	1.2%
Media	Market Weight	1.1%
Retailing	Underweight	1.3%
Consumer Staples	**Underweight**	**3.6%**
Food & Staples Retailing	Underweight	2.8%
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**	**34.4%**
Banks	Overweight	23.5%
Diversified Financials	Market Weight	4.0%
Insurance	Overweight	6.9%
Information Technology	**Overweight**	**3.3%**
Software & Services	Overweight	2.8%
Technology Hardware & Equipment	Market Weight	0.5%
Telecommunication Services	**Underweight**	**4.8%**
Utilities	**Underweight**	**3.8%**
Real Estate	**Underweight**	**2.8%**

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

Monthly Equity Monitor

Economics and Strategy

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