July-August 2017

Highlights

- The first half of 2017 has been good for global equity markets. Encouragingly, markets are being lifted by earnings growth rather than P/E expansion. At this writing, the consensus expects MSCI AC index earnings to grow 12.4% over the next 12 months.
- The S&P 500 rose to a new all-time high in June, with eight of the 11 major sectors setting new records. With a forward P/E of about 18, the S&P 500 has become expensive compared to its global peers. While we are comforted to see that upward earnings revisions for the S&P 500 companies are the most widespread in three years, we see this development more as a guard against downside than as a harbinger of significant upside.
- At mid-year the S&P/TSX remains one of the worst-performing country benchmarks. Energy, Banks and Materials have all struggled in Q2. We expect these sectors to do better in the second half of the year. The domestic economy remains sound and corporate profits have rebounded.
- We are changing our asset allocation this month by reducing our cash position in favour of Canadian equities. Our decision is based on our view that global economic momentum will improve in the second half of the year. This development argues for a reflation trade scenario, implying a somewhat weaker U.S. dollar and stronger commodity prices.
- In sector rotation, we are increasing our recommendation for Energy stocks from underweight to market weight. Telecoms, real estate and utilities are downgraded to an underweight recommendation.

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Outlook still constructive

The first half of 2017 has been good for global equity markets — a total return of 10.1%. So far this year the heavy lifting has been done by Emerging Asia, Europe and the U.S. (table).

MSCI composite index: Price Performance (Total return)

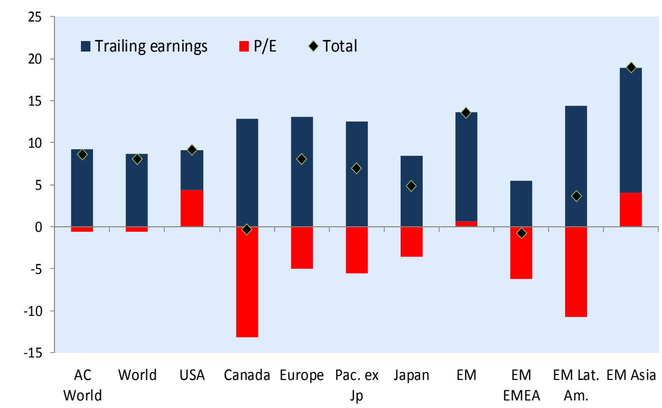
	Month to date	Quarter to date	Year to date
MSCI AC World	1.0	4.0	10.1
MSCI World	0.9	3.7	9.5
MSCI USA	1.2	3.7	10.2
MSCI Canada	-0.2	-1.2	0.9
MSCI Europe	-0.2	4.3	10.8
MSCI Pacific ex Jp	0.0	0.9	9.0
MSCI Japan	2.6	6.0	5.9
MSCI EM	1.4	6.4	14.7
MSCI EM EMEA	-1.7	1.0	1.0
MSCI EM Latin America	-1.3	-2.4	5.1
MSCI EM Asia	2.5	9.2	19.8

6/23/2017

NBF Economics and Strategy (data via Datastream)

Encouragingly, markets are being lifted by earnings growth rather than P/E expansion. In fact trailing P/Es have declined in most regions since the beginning of the year (chart).

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

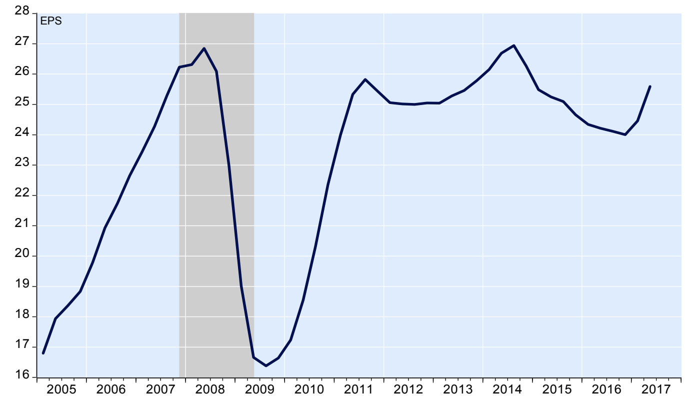


NBF Economics and Strategy (data via Datastream)

As the next chart illustrates, profits continue to recover from their debacle of 2014-16. In our opinion, earnings could still surprise on the upside in the coming months.

World: Profits are still recovering

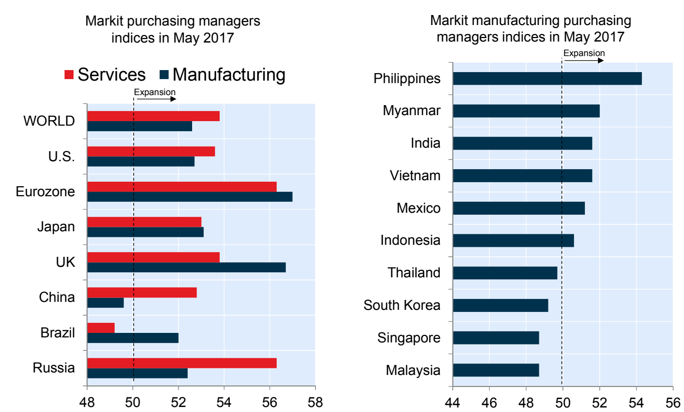
Trailing earnings for the MSCI AC



NBF Economics and Strategy (data via Dastastream)

World trade volume continues to grow faster than industrial production, pushing the ratio of industrial production to trade volume (a proxy for inventories) to the lowest in years. That's good news for production going forward. And to judge by Markit purchasing manager indexes, the global economy continued to expand in the second quarter. Most of the advanced and emerging economies are showing increases in both manufacturing and services output (chart).

World: Continued expansion in the second quarter

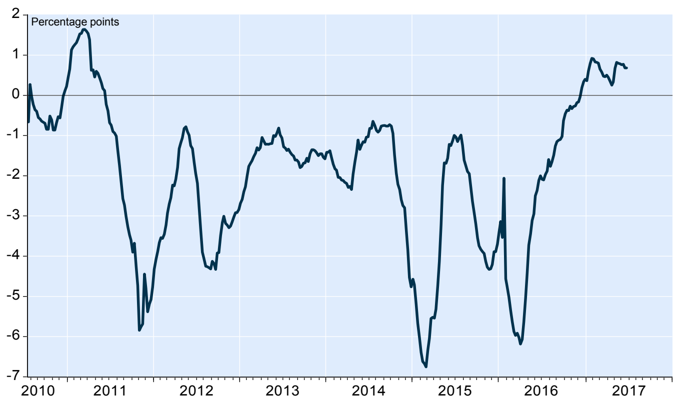


NBF Economics and Strategy (data via Markit)

The improving economic backdrop is conducive to upward earnings revisions. The bottom-up consensus of equity analysts for 12-month-forward earnings of the MSCI AC has been revised up every week since the beginning of the year (chart). As long as this continues, equity markets have limited downside. At this writing, the consensus expects MSCI AC index earnings to grow 12.4% over the next 12 months (table).

Monthly Equity Monitor

World: Earnings still being revised up
3-month change in 12-month-forward MSCI AC earnings growth



NBF Economics and Strategy (data via Datastream)

MSCI composite index: EPS Performance

	2016	2017	2018	2019	12 months forward
MSCI AC World	2.0	14.5	10.7	9.9	12.4
MSCI World	1.1	13.6	10.6	9.7	11.8
MSCI USA	2.3	10.6	12.3	10.7	11.5
MSCI Canada	-4.5	23.2	11.5	12.3	16.4
MSCI Europe	-3.9	18.9	9.2	9.0	13.1
MSCI Pacific ex Jp	-7.8	16.3	4.8	5.6	6.4
MSCI Japan	NA	16.1	12.1	7.5	10.8
MSCI EM	7.8	20.4	11.4	10.8	16.0
MSCI EM EMEA	6.2	13.9	14.8	7.5	16.2
MSCI EM Latin America	59.4	24.8	8.8	17.9	16.3
MSCI EM Asia	2.8	21.4	11.0	10.4	15.9

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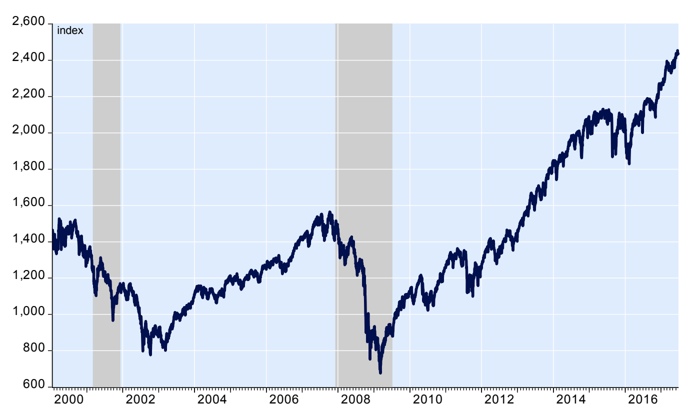
NBF Economics and Strategy (data via Datastream)

U.S.: The economy must deliver

The S&P 500 rose to a new all-time high in June, with eight of the 11 major sectors setting new records. At this juncture, the outlooks for both economic growth and profits remain encouraging.

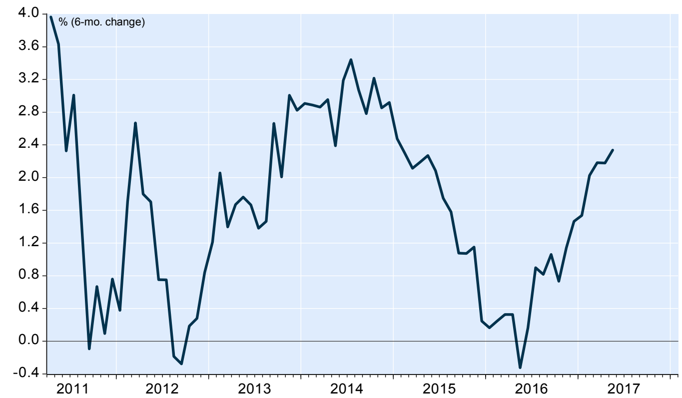
U.S.: A new record in June
S&P 500



NBF Economics and Strategy (data via Datastream)

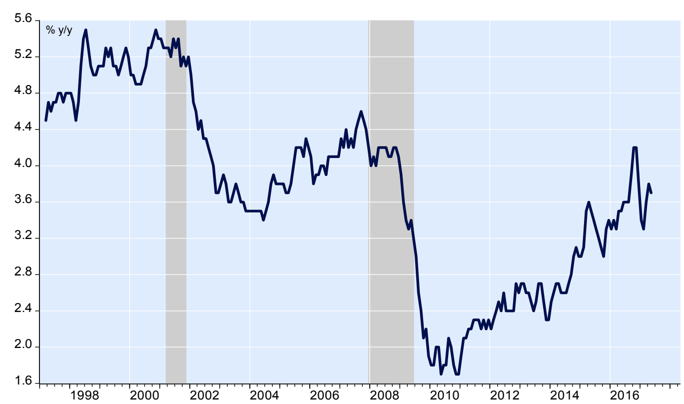
First, the uptrend of the U.S. leading economic indicator is the most pronounced in three years (chart). Second, more than 1.3 million full-time jobs were added in the first five months of 2017. As the labour market continues to tighten, full-time workers are enjoying higher wage growth (chart). We remain confident that this will translate into faster growth of consumer spending in the second half of the year.

U.S.: Economic outlook still constructive
Growth in the leading economic indicator



NBF Economics and Strategy (Conference Board data via Dastastream)

U.S.: Improved consumer purchasing power
Growth of median wage of people who usually work full-time



NBF Economics and Strategy (data via Atlanta Federal Reserve)

Much of this good news, however, is already embedded in U.S. equity prices. With a forward P/E of about 18, the S&P 500 have become expensive compared to its global peers (table). While we are comforted to see that upward earnings revisions for the S&P 500 companies are the most widespread in three years (chart, next page), we see this development more as a guard against downside than as a harbinger of significant upside.

Monthly Equity Monitor

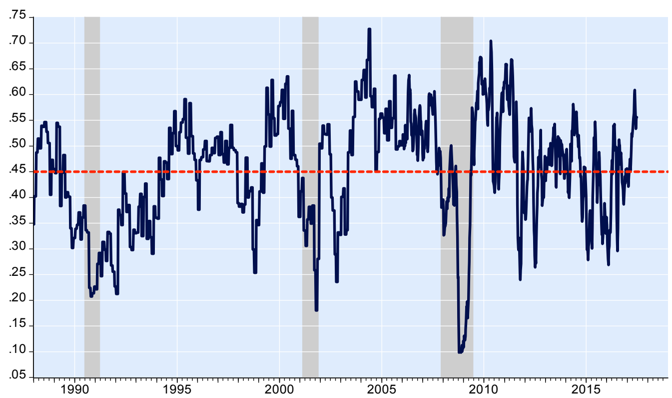
NATIONAL BANK OF CANADA FINANCIAL MARKETS

MSCI Composite Index: Valuations (forward P/Es)

	6/23/2017	A year ago	10 year ave.	5 year average
MSCI AC World	16.0	15.3	13.3	14.4
MSCI World	16.6	15.8	13.6	14.9
MSCI USA	18.0	16.9	14.4	15.8
MSCI Canada	15.0	16.5	14.0	14.8
MSCI Europe	15.1	14.7	12.2	13.8
MSCI Pacific ex Jp	15.4	15.0	13.8	14.5
MSCI Japan	14.3	13.0	14.8	13.7
MSCI EM	12.1	11.8	11.0	11.0
MSCI EM EMEA	9.8	10.2	9.0	9.2
MSCI EM Latin America	12.1	13.1	11.9	12.7
MSCI EM Asia	12.7	12.0	11.7	11.2

NBF Economics and Strategy (data via Datastream)

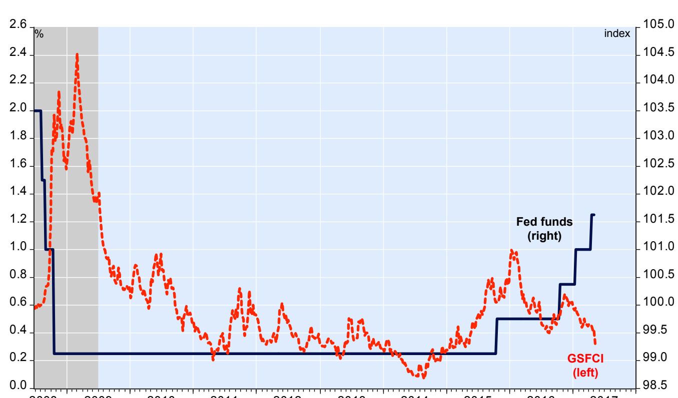
U.S.: Diffusion of upward earnings revisions
Fraction of S&P 500 companies whose 12-month-forward earnings has been revised up over the past 3 months



NBF Economics and Strategy (data via Dastastream)

Given the current economic backdrop, we expect Treasury yields to head higher before the year end. Our target for the 10-year note is 2.7%. Rising yields notwithstanding, we expect financial conditions in the U.S. to remain pro-growth. Even after four Federal Reserve rate hikes, the financial conditions index (an aggregate of interest rates, the stock market, corporate spreads and the USD) is the most accommodative in three years (chart).

U.S.: Financial conditions still easing
GS financial conditions index and federal funds rate



NBF Economics and Strategy (data via Bloomberg)

Canada: Rebound in the offing

At mid-year the S&P/TSX remains one of the worst-performing country benchmarks. Energy, Banks and Materials have all struggled in Q2 (table).

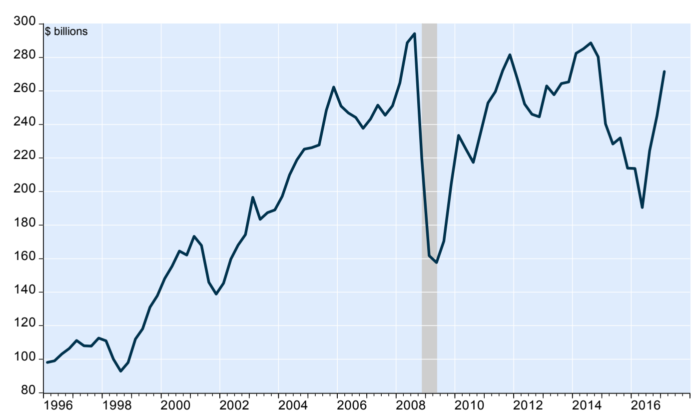
S&P/TSX composite index: Price Performance

	Month to date	Quarter to date	Year to date
S&P TSX	-0.2	-1.5	0.2
HEALTH CARE	11.2	10.8	-0.7
BANKS	2.2	-2.5	1.0
FINANCIALS	2.0	-2.0	0.5
UTILITIES	1.8	3.3	9.6
INDUSTRIALS	1.0	6.7	12.0
CONS. DISC.	0.8	5.6	12.4
REAL ESTATE	0.4	1.6	5.0
IT	-0.1	6.7	14.0
MATERIALS	-0.8	-3.4	2.2
TELECOM	-2.3	2.8	6.8
CONS. STAP.	-3.3	1.2	3.5
ENERGY	-3.9	-8.6	-14.3

6/23/2017
NBF Economics and Strategy (data via Datastream)

We expect these sectors to do better in the second half of the year. The domestic economy remains sound. Nominal GDP has expanded at more than 7% annualized for three consecutive quarters, the best run since 2004. Corporate profits have rebounded accordingly and are back almost to the level of 2014 (chart).

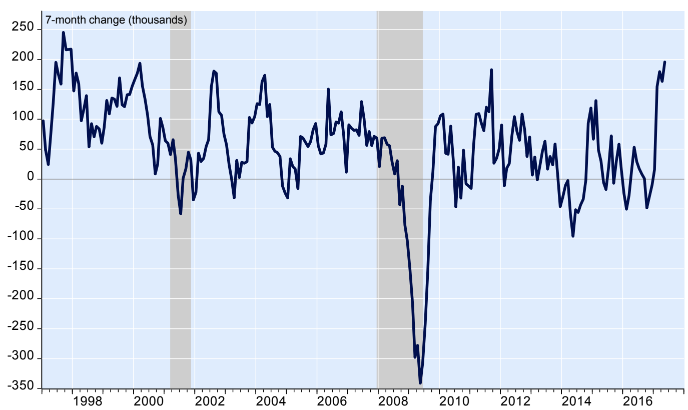
Canada: Profits have rebounded
Corporate profits



NBF Economics and Strategy (data via Statistics Canada)

Better profits have also meant a sizeable increase in full-time employment for prime-aged workers (25 to 54 years old). Their ranks have swelled by almost 200,000 since the end of last year, the best run in two decades (chart). This hiring supports credit growth, consumer spending and the housing market. It also means that the Bank of Canada is likely to raise interest rates before year end. We expect that these developments will reassure investors about the prospects for Canadian banks and improve sentiment toward the S&P/TSX.

Canada: Full-time employment is surging
Full-time employment for 25-54 population

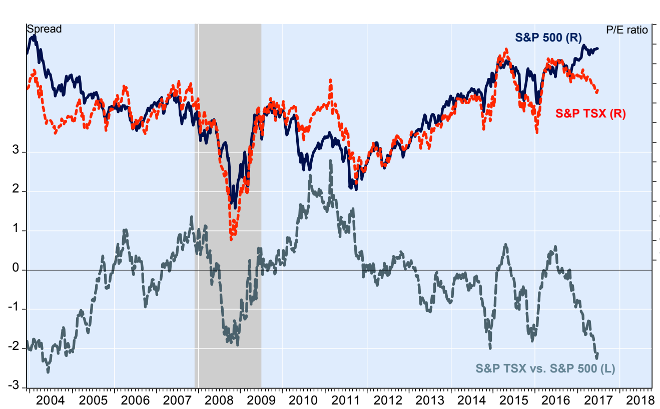


NBF Economics and Strategy (data via Statistics Canada)

Asset allocation

We are changing our asset allocation this month by reducing our cash position in favour of Canadian equities. Our decision is based on our view that global economic momentum will improve in the second half of the year. This development argues for a reflation trade scenario, implying a somewhat weaker U.S. dollar and stronger commodity prices. That should buoy the S&P/TSX, which is currently trading at a significant discount to the S&P 500. At this writing, the spread between the 12-month-forward P/Es of the S&P 500 and the S&P/TSX is the widest since 2004 (chart).

S&P TSX: Perspective on relative equity valuation
Price to 12 month forward earnings (weekly data)

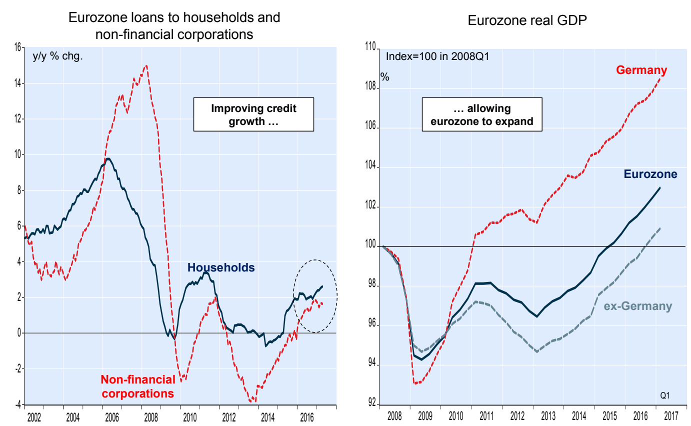


NBF Economics and Strategy (data via Datastream)

Given our more constructive view on Europe, we are also increasing our allocation to EAFE stocks to the detriment of the U.S. The Eurozone's outlook has improved markedly since the start of the year. The composite PMIs in both Germany and France jumped to six-year highs in May.

Consumption spending is holding up well in both of those Eurozone powerhouses, with France's retail PMI even surging in May to the highest in 67 months. According to Markit, the overall data paints a positive picture of the retail sector in the Eurozone. The uptick in credit growth for households is no doubt helping (chart). But so is rising employment. Latest Eurostat data shows employment rising to an all-time high in Q1, surpassing the 2008 peak for the first time.

Eurozone: Credit growth fueling expansion



NBF Economics and Strategy (data via Eurostat)

Sector rotation

In sector rotation, we are increasing our recommendation for Energy stocks from underweight to market weight. This move is consistent with our current year end target of US$50 for WTI. To accommodate this change, we are reducing telecoms, utilities and real estate to underweight as those sectors are vulnerable to a rise in interest rates.

NBF Asset Allocation

	Benchmark (%)	NBF Recommendation (%)	Change (pp)
Equities			
Canadian Equities	20	24	+3
U.S. Equities	20	17	-3
Foreign Equities (EAFE)	5	8	+3
Emerging markets	5	5	
Fixed Income	45	39	
Cash	5	7	-3
Total	100	100	

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Monthly Equity Monitor

NBF Market Forecast *Canada*			
		Actual	***Q42017 (Est.)***
Index Level		**Jun-27-17**	***Target***
S&P/TSX		15,281	16,100
Assumptions			Q42017 (Est.)
Level:	Earnings *	820	875
	Dividend	432	462
PE Trailing (implied)		18.6	18.4
			Q42017 (Est.)
Treasury Bills (91 days)		0.57	1.13
10-year Bond Yield		1.57	2.26

** Before extraordinary items, source Thomson*

NBF Economics and Strategy

NBF Market Forecast *United States*			
		Actual	***Q42017 (Est.)***
Index Level		**Jun-27-17**	***Target***
S&P 500		2,419	2,500
Assumptions			Q42017 (Est.)
Level:	Earnings *	123	130
	Dividend	49	51
PE Trailing (implied)		19.6	19.2
			Q42017 (Est.)
Treasury Bills (91 days)		0.99	1.36
10-year Bond Yield		2.20	2.71

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

NATIONAL BANK OF CANADA FINANCIAL MARKETS

NBF Fundamental Sector Rotation - July/August 2017

Name (Sector/Industry)	Recommendation	S&P/TSX weight
Energy	**Market Weight**	**20.0%**
Energy Equipment & Services	Market Weight	0.5%
Oil, Gas & Consumable Fuels	Market Weight	19.4%
Materials	**Market Weight**	**11.6%**
Chemicals	Underweight	2.0%
Containers & Packaging	Market Weight	0.6%
Metals & Mining *	Market Weight	8.4%
Gold	Market Weight	5.9%
Paper & Forest Products	Overweight	0.5%
Industrials	**Market Weight**	**9.6%**
Capital Goods	Overweight	2.0%
Commercial & Professional Services	Underweight	1.7%
Transportation	Market Weight	6.0%
Consumer Discretionary	**Underweight**	**5.4%**
Automobiles & Components	Underweight	1.2%
Consumer Durables & Apparel	Overweight	0.6%
Consumer Services	Underweight	1.2%
Media	Market Weight	1.1%
Retailing	Underweight	1.3%
Consumer Staples	**Underweight**	**3.9%**
Food & Staples Retailing	Underweight	3.1%
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	**Overweight**	**34.2%**
Banks	Overweight	23.4%
Diversified Financials	Market Weight	4.3%
Insurance	Overweight	6.5%
Information Technology	**Overweight**	**3.3%**
Software & Services	Overweight	2.8%
Technology Hardware & Equipment	Market Weight	0.5%
Telecommunication Services	**Underweight**	**4.9%**
Utilities	**Underweight**	**3.3%**
Real Estate	**Underweight**	**3.0%**

Monthly Equity Monitor

Economics and Strategy

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