Monthly Equity Monitor

Economics and Strategy

March-April 2018

Highlights

- For the first time since the last recession, Treasuries have been insensitive to the grievances of the stock market. Whether equity markets like it or not, the 10-year yield seems to be on the way to 3% faster than expected.
- When long-term interest rates are on the rise, the biggest vulnerability of equity markets is valuation. As we have noted in the past, P/E expansion is not the norm at this point in the economic cycle (the mature phase). For the market to move higher, earnings will need to keep growing.
- Forward earnings estimates for all main sectors of the S&P 500 except Real Estate have been revised up in recent weeks. A key risk factor for the profit outlook is the apparent U.S. tilt to protectionism. After all, the foreign share of S&P 500 sales is more than 40 per cent.
- The S&P/TSX continues to struggle. What ails Canadian equities? The answer is P/E compression due to NAFTA uncertainty and household debt. In our view, the current pessimism about the S&P/TSX is overdone.
- Our asset allocation is unchanged this month. We continue to prefer stocks over bonds. That said, it is important to remain on the watch for any unexpected pickup in inflationary pressure that would compromise the profit outlook by pushing the 10-year Treasury yield above the comfort zone of the economy. For the U.S. we peg the ceiling of that zone at around 3.5%.
- We are making a slight change in our sector allocation this month. We are reducing our exposure to IT from overweight to market weight. We are putting our IT gains into golds, which we move from market weight to overweight. Central bank commitments to normalize monetary policy very slowly imply a tolerance for inflation that is likely to benefit bullion. The price of gold will also gain from resurgent volatility if Washington opts to push more aggressively for trade barriers against non-NAFTA trading partners.

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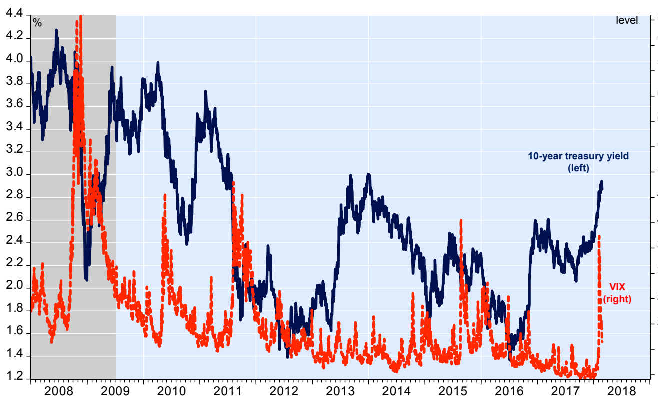
A more volatile environment

Early in February global equities went through a correction worse than any since August 2015, when China surprised markets with a devaluation of the renminbi. This time around, the surge in volatility and the drop in equity markets was triggered not by China but by 10-year U.S. Treasuries. For the first time since the last recession, Treasuries have been insensitive to the grievances of the stock market. Whether equity markets like it or not, the 10-year yield seems to be on the way to 3% faster than expected. Will that level turn out to be more than the economy can handle, precipitating a wave of downward earnings revisions? We don't think so, but we do expect a period of consolidation as rising rates push investors to reassess fair value for a number of asset classes.

World: The 10-year Treasury spooks equity markets
Yield on 10-year U.S. Treasury and S&500 volatility index



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Before the February episode there had been only 10 instances since 1988 when volatility (the VIX index) rose to 35 or higher. On those occasions the S&P 500 hit a bottom an average 32 trading days after the initial surge in volatility with an average drawdown of 9.7%. However, this period includes three recessions (1990-91, 2001 and 2007-09). Considering only VIX surges outside recessions, the S&P 500 bottomed an average 37 trading days after the initial surge with an average drawdown of 5.2% (median 3.4%). In the current episode, the drawdown bottomed at 2.6% on February 8, three days after the VIX hit 35 (table). So the rebound started relatively quickly this time around.

Perspective on the S&P 500 performance after VIX hit 35

Date VIX hit 35	Date market bottomed out	Time elapsed (in trading days)	Size of the drop
1990/08/06*	10/11/1990	47	11.7%
1/14/1991	1/14/1991	0	0.0%
10/30/1997	10/30/1997	0	0.0%
8/27/1998	8/31/1998	2	8.2%
2001/09/17*	9/21/2001	4	7.0%
7/15/2002	10/9/2002	61	15.4%
2008/09/17*	10/3/2008	12	41.5%
5/7/2010	7/2/2010	39	7.9%
8/8/2011	10/3/2011	39	1.8%
8/24/2015	2/11/2016	118	3.4%
2/5/2018	2/8/2018	3	2.6%
	Average	**32.2**	**9.7%**

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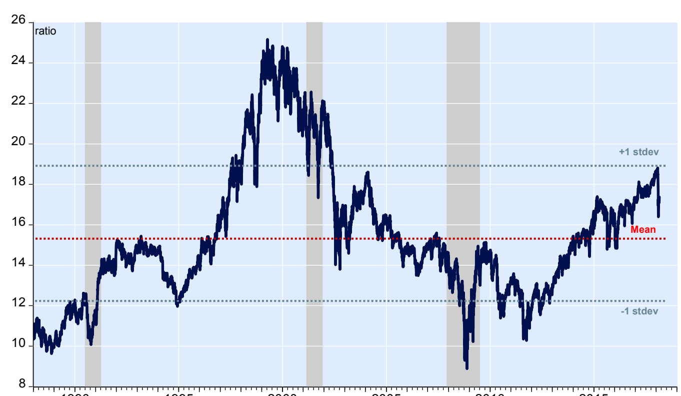
When long-term interest rates are on the rise, the biggest vulnerability of equity markets is valuation. Before the recent pullback, the forward P/E of the S&P 500 was 19, a full standard deviation above its long-term mean (chart). The recent correction has taken it down to about 17. As for the MSCI AC, its current forward P/E of 15.4 is near the historical average. As we have noted in the past, P/E expansion is not the norm at this point in the economic cycle (the mature phase). For the market to move higher, earnings will need to keep growing.

U.S.: Valuations are less stretched
S&P 500 12-month-forward P/E



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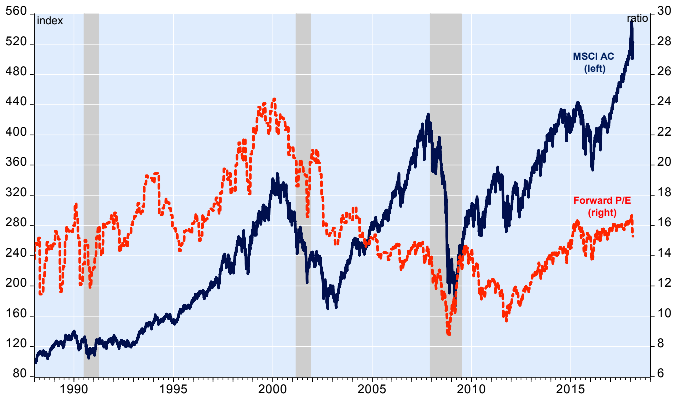
World: Perspective on global equities
MSCI AC and its 12-month-forward P/E



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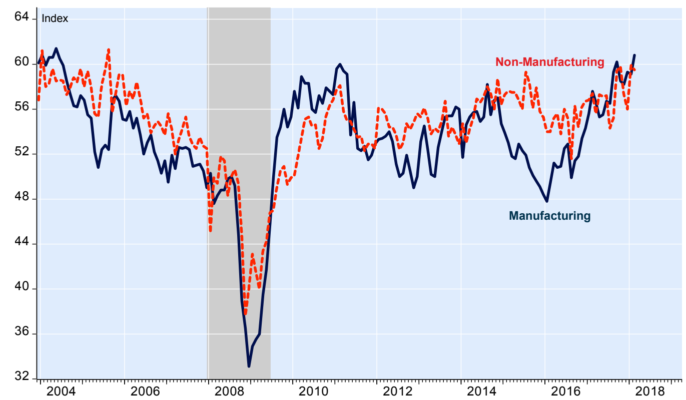
U.S.: Private sector growing at healthy pace
ISM manufacturing and non-manufacturing indices. Last observation: February 2018



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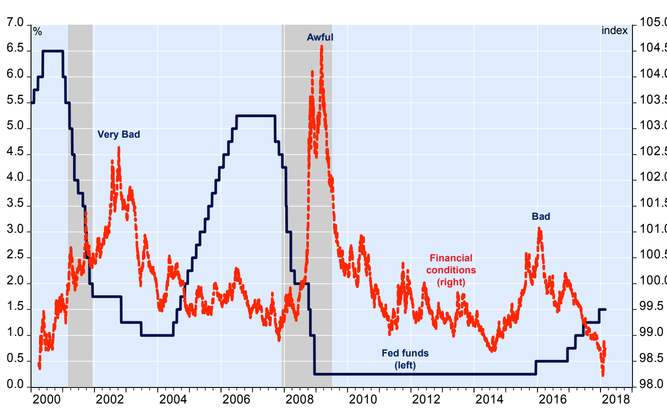
So far, companies have certainly been delivering. For S&P 500 constituents in Q4, 76% had sales and 78% had earnings that beat analyst expectations. The only sector whose Q4 results have disappointed is oil & gas. But what about the outlook? For profits to continue surprising on the upside, financial conditions in general (not just monetary policy) must remain supportive. It is important to note that even after the recent correction, the GS index of U.S. financial conditions (a composite of interest rates, exchange rate, corporate spreads and equity market) is as stimulative as it was in 2014 before the Federal Reserve started raising its policy rate. Financial conditions are also much less restrictive than in 2015-2016 when the VIX last spiked above 35 (chart).

U.S.: Financial conditions have deteriorated, but not by much
GS financial conditions index vs. Fed funds rate

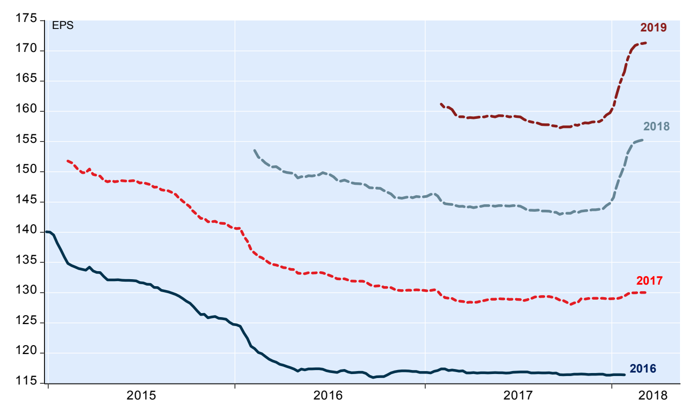


NBF Economics and Strategy (data via Bloomberg as of Feb 23, 2018)

With financial conditions as pro-growth as they are now, the economy can be expected to continue expanding at a fairly brisk pace. Importantly, the ISM diffusion indexes for U.S. manufacturing and non-manufacturing industries are consistent with broad-based growth (chart).

This development, coupled with the Trump administration's recent success in implementing its pro-business agenda of tax cuts and deregulation, has been reflected in earnings revisions. Forward earnings estimates for all main sectors of the S&P 500 except Real Estate have been revised up in recent weeks. At this writing, the bottom-up consensus of equity analysts expects S&P 500 index earnings to reach $155 in 2018 chart).

S&P 500: Earnings continue to be revised up
Evolution of earnings expectations by calendar years



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In the latest round of revisions, the consensus has raised its expectations for index earnings growth to 19.5% in 2018 followed by a robust 10.3% in 2019. With so much good news now priced in, the S&P 500 is more vulnerable to disappointment. A key risk factor for the profit outlook is the apparent U.S. tilt to protectionism. After all, the foreign share of S&P 500 sales is more than 40 per cent (chart).

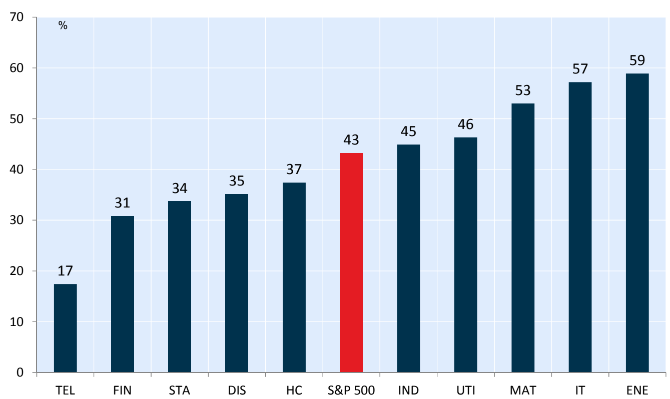
S&P 500 composite index: EPS Performance

	2017	2018	2019	2020	12 months forward
S&P 500	11.7	19.5	10.3	10.3	16.2
ENERGY	360.0	70.1	11.4	19.8	48.8
MATERIALS	15.4	23.1	9.8	13.3	19.0
INDUSTRIALS	4.3	18.8	12.5	10.8	16.9
CONS. DISC.	6.4	16.9	12.2	13.1	15.4
CONS. STAP.	5.8	11.5	8.5	8.9	10.6
HEALTH CARE	8.2	11.4	9.7	9.0	11.0
FINANCIALS	8.4	29.3	10.6	9.4	23.6
IT	18.1	19.1	10.9	10.4	14.3
TELECOM	-0.2	15.0	1.2	-1.1	11.2
UTILITIES	2.8	4.8	5.4	5.6	4.9
REAL ESTATE	-13.0	-15.8	9.5	8.4	-10.2

3/13/2018

NBF Economics and Strategy (data via Datastream)

U.S.: Foreign sales are an important component of earnings
Foreign sales as a percentage of total sector sales in S&P 500 (2016)



NBF Economics and Strategy (data via https://us.spindices.com/documents/research/research-sp-500-2016-global-sales.pdf)

Canada: Still struggling

The S&P/TSX continues to struggle. The Canadian benchmark is down 3.5% so far in 2018 with declines in all main sectors except IT (table).

S&P/TSX composite index: Price Performance

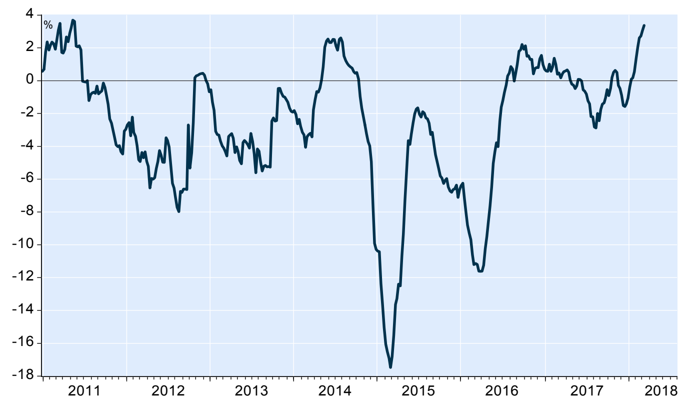
	Month to date	Quarter to date	Year to date
S&P TSX	1.3	-3.5	-3.5
HEALTH CARE	5.7	-8.9	-8.9
IT	4.6	16.7	16.7
MATERIALS	2.4	-2.3	-2.3
TELECOM	1.7	-5.0	-5.0
REAL ESTATE	1.5	-0.9	-0.9
BANKS	1.4	-0.3	-0.3
FINANCIALS	1.3	-1.8	-1.8
UTILITIES	1.3	-7.3	-7.3
ENERGY	1.2	-10.5	-10.5
CONS. STAP.	0.7	-3.9	-3.9
CONS. DISC.	-0.2	-3.9	-3.9
INDUSTRIALS	-0.4	-1.0	-1.0

3/13/2018

NBF Economics and Strategy (data via Datastream)

What's keeping the S&P/TSX down? Not earnings. The Q4 reporting season has been relatively good — 56% of TSX companies beat earnings expectations. What's more, the outlook remains upbeat: earnings revisions have been the best since 2011 (chart).

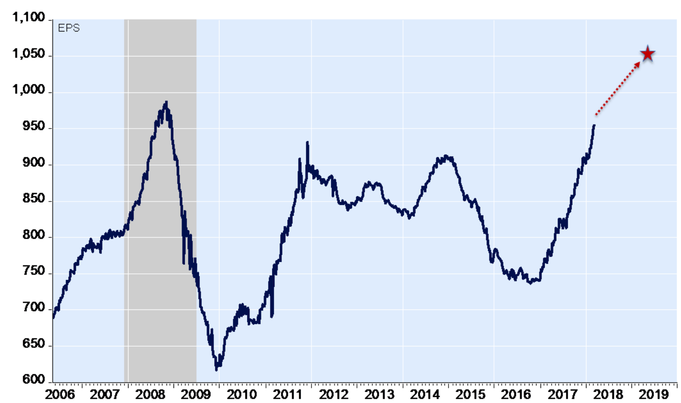
Canada: Earnings revisions are the most positive since 2011
3-month change in 12-month forward earnings for the S&P/TSX



NBF Economics and Strategy (data via Datastream)

The bottom-up analyst consensus expects S&P/TSX earnings per share to rise to $1052 over the next 12 months, topping the 2008 record (chart). We see this as not unreasonable if the global economy proves as resilient as we think it will.

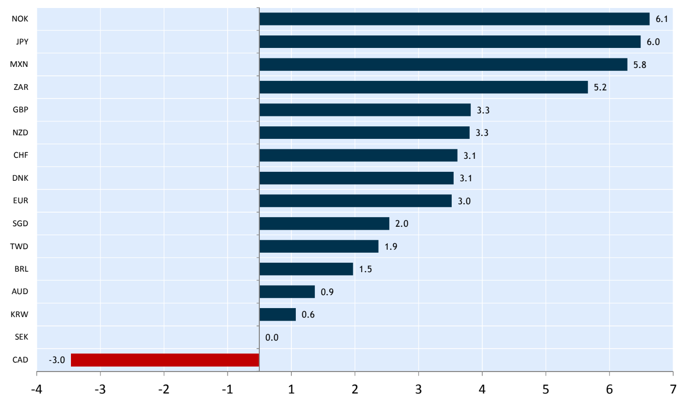
Canada: Earnings expected to hit a record
Trailing earnings for the S&P/TSX



NBF Economics and Strategy (data via Datastream)

So if it's not earnings, what ails Canadian equities? The answer is P/E compression due to NAFTA uncertainty and household debt. NAFTA termination would set Canada seriously back, braking the economy through labour market deterioration and its effect on the housing market and consumer balance sheets. These concerns are clearly apparent in the performance of the Canadian dollar. It is the only major currency that has slipped against the USD in 2018 to date (chart).

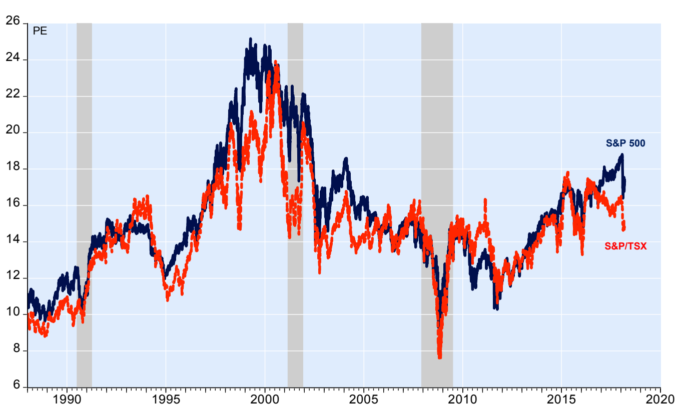
Canada: A bad performance for the CAD so far in 2018
Performance of major currencies vs. the USD (as of March 14, 2018)



NBF Economics and Strategy (data via Bloomberg)

In our view, the current pessimism about the CAD and the S&P/TSX is overdone. We think the best argument against NAFTA termination is the continued improvement of the U.S. labour market and the resulting U.S. labour shortages. Canada's job market has also been resilient early in 2018 and consumers are benefiting from pro-cyclical fiscal stimulus. 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. We also think a deal could be reached as soon as this spring. That would certainly help the S&P/TSX, which is currently trading at a sizeable discount to the S&P 500 (chart).

Canada: S&P/TSX at a discount to the S&P 500
Forward PEs for the S&P 500 and the S&P/TSX



NBF Economics and Strategy (data via Datastream)

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 pressure that would compromise the profit outlook by pushing the 10-year Treasury yield above the comfort zone of the economy. For the U.S. we peg the ceiling of that zone at around 3.5%.

Sector rotation

We are making a slight change in our sector allocation. We are reducing our exposure to IT from overweight to market weight. This sector has done extremely well over the past year, returning 28%. It is trading at a forward P/E of 25, well above its historical average of just under 20. We are putting our IT gains into golds, which we move from market weight to overweight. Central bank commitments to normalize monetary policy very slowly imply a tolerance for inflation that is likely to benefit bullion. The price of gold will also gain from resurgent volatility if Washington opts to push more aggressively for trade barriers against non-NAFTA trading partners.

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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NATIONAL BANK OF CANADA FINANCIAL MARKETS

NBF Market Forecast *Canada*			
		Actual	***Q42018 (Est.)***
Index Level		**Mar-15-18**	***Target***
S&P/TSX		15,671	16,700
Assumptions			Q42018 (Est.)
Level:	Earnings *	955	1021
	Dividend	458	489
PE Trailing (implied)		16.4	16.4
			Q42018 (Est.)
Treasury Bills (91 days)		1.07	1.88
10-year Bond Yield		2.15	2.68

** Before extraordinary items, source Thomson*

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NBF Market Forecast *United States*			
		Actual	***Q42018 (Est.)***
Index Level		**Mar-15-18**	***Target***
S&P 500		2,747	2,950
Assumptions			Q42018 (Est.)
Level:	Earnings *	138	152
	Dividend	51	56
PE Trailing (implied)		20.0	19.4
			Q42018 (Est.)
Treasury Bills (91 days)		1.74	2.10
10-year Bond Yield		2.83	3.17

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

NBF Fundamental Sector Rotation - March 2018

Name (Sector/Industry)	Recommendation	S&P/TSX weight
Energy	**Overweight**	**18.0%**
Energy Equipment & Services	Overweight	0.5%
Oil, Gas & Consumable Fuels	Overweight	17.5%
Materials	**Overweight**	**11.6%**
Chemicals	Underweight	2.3%
Containers & Packaging	Market Weight	0.6%
Metals & Mining *	Overweight	3.1%
Gold	Overweight	4.9%
Paper & Forest Products	Overweight	0.6%
Industrials	**Market Weight**	**9.7%**
Capital Goods	Overweight	2.3%
Commercial & Professional Services	Underweight	1.8%
Transportation	Market Weight	5.6%
Consumer Discretionary	**Underweight**	**5.5%**
Automobiles & Components	Underweight	1.4%
Consumer Durables & Apparel	Overweight	0.6%
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**	**0.9%**
Health Care Equipment & Services	Market Weight	0.2%
Pharmaceuticals, Biotechnology & Life Sciences	Market Weight	0.7%
Financials	**Market Weight**	**35.3%**
Banks	Market Weight	24.6%
Diversified Financials	Market Weight	3.9%
Insurance	Market Weight	6.8%
Information Technology	**Market Weight**	**4.0%**
Software & Services	Market Weight	3.8%
Technology Hardware & Equipment	Market Weight	0.2%
Telecommunication Services	**Underweight**	**4.6%**
Utilities	**Underweight**	**3.7%**
Real Estate	**Underweight**	**3.0%**

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

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