NATIONAL BANK OF CANADA
FINANCIAL MARKETS

Monthly Equity Monitor

Economics and Strategy

June-July 2018

Highlights

- The outlook for global equity markets has become suddenly more doubtful because of a looming trade war between the U.S. and its trading partners.
- This occurs at a time when the Federal Reserve remains inclined to hike a few more times in 2018 despite strengthening of the U.S. dollar. This combination could pose a challenge to earnings growth and thus to equity markets, since P/E expansion is very hard to come by at this point in the economic cycle.
- The last few weeks have not been easy for Canada-U.S. relations. NAFTA talks that recently seemed on the verge of success have collapsed.
- Escalating trade tensions prompt us to change our asset mix recommendation. We are reducing our equity exposure by three percentage points in favour of cash. The S&P/TSX has done well in recent months and is closing in on our year-end target of 16,700. Though a weaker Canadian dollar will buoy earnings in a number of sectors, there is a limit to what the exchange rate alone can achieve if U.S. trade policy turns more aggressive on Canadian products.
- We are modifying our sector rotation this month to reflect our more cautious view, reducing our exposure to Energy, Materials (except golds) and Industrials and increasing our exposure to Telecoms, Utilities and Real Estate.

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Monthly Equity Monitor

The fog of trade war

The outlook for global equity markets has become suddenly more doubtful because of a looming trade war between the U.S. and its trading partners. Washington's June 1 imposition of tariffs on steel and aluminum from Canada, Mexico and the European Union led these countries to announce tariffs of their own on U.S. goods effective in July. Then on June 16, China announced it would retaliate tit-for-tat (same amounts on same dates) if the U.S. went ahead with its announced tariffs on $50 billion worth of Chinese imports. Beijing said it would apply a 25% levy on $34 billion in imports of U.S. farm products and autos on July 6 and tariffs on another $16 billion of U.S. goods (including coal and oil) at a later date. Not to be outdone, President Trump now threatens to impose tariffs on an additional $200 billion in Chinese goods and to go as high as $400 billion. In addition, Washington has scheduled the release June 30 of a proposal to limit Chinese investment in the U.S. unless Beijing agrees to ease restrictions on U.S. investment in China.

So the geopolitical front is becoming much more fraught, at a time when the Federal Reserve remains inclined to hike a few more times in 2018 despite strengthening of the U.S. dollar. This combination could pose a challenge to earnings growth and thus to equity markets, since P/E expansion is very hard to come by at this point in the economic cycle (its mature phase). As the table below shows, the bottom-up consensus of equity analysts is for robust 14.6% earnings growth over the coming year.

S&P 500 composite index: EPS Performance

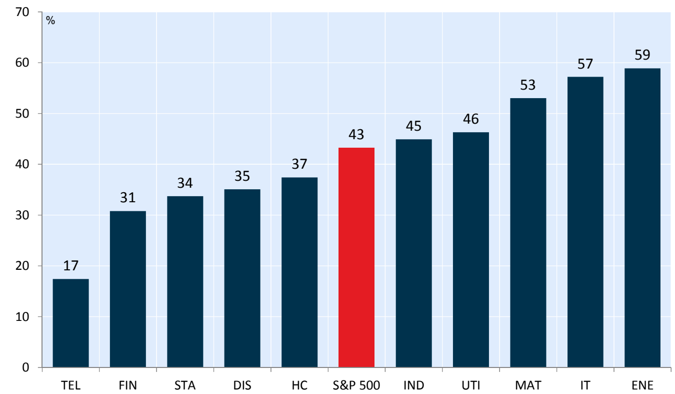
	2017	2018	2019	2020	12 months forward
S&P 500	11.8	22.1	9.8	10.3	14.6
ENERGY	342.5	94.0	15.3	10.9	42.0
MATERIALS	15.4	25.9	8.3	12.7	16.0
INDUSTRIALS	4.7	19.2	12.8	11.0	15.6
CONS. DISC.	6.6	19.1	12.1	13.7	15.2
CONS. STAP.	6.2	11.8	7.5	8.1	9.1
HEALTH CARE	8.0	12.9	8.7	9.1	10.7
FINANCIALS	8.5	30.5	9.9	10.3	18.8
IT	18.5	22.9	9.6	11.2	12.7
TELECOM	-0.2	14.0	1.8	0.8	7.5
UTILITIES	2.8	5.9	5.3	4.8	5.6
REAL ESTATE	-12.9	-12.7	4.5	8.8	-4.7

6/15/2018

NBF Economics and Strategy (data via Datastream)

Until last week we assumed Mr. Trump would avoid a trade war because of the risks to U.S. earnings. After all, foreign sales account for 43% of all sales of the S&P 500 companies (chart). Alas, that doesn't seem to be the case. There is of course still time between now and July 6 to avoid a tariff war, but the window is getting pretty small.

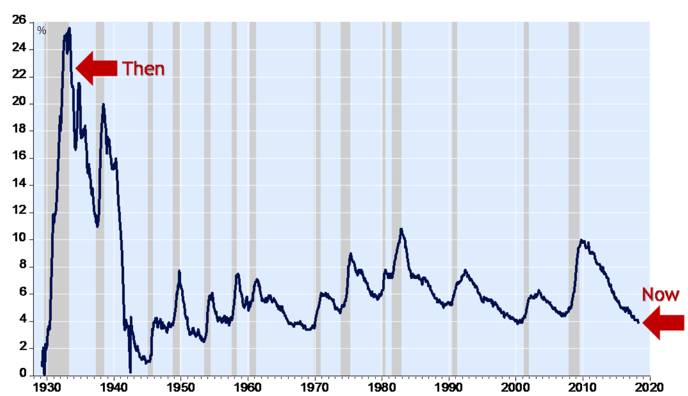
U.S.: Foreign sales are a big factor in S&P 500 earnings
Foreign sales as % of total sales of S&P 500 sectors (2016)



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

Washington's aggressive moves on trade appear to be driven by politics rather than economics. In the 1930s, a global trade war broke out when the U.S. jobless rate had zoomed into double digits (chart). Today employment is full, wages are rising and labour shortages are reported in a number of industries. Globalization still seems to be serving the U.S. economy well.

U.S.: Unusual timing for a trade war
Unemployment rate



NBF Economics and Strategy (data via Datastream and NBER)

For U.S. multinationals, new or higher tariffs on imported inputs when the labour market is tight will likely squeeze profit margins. At this writing, the bottom-up consensus of equity analysts continues to see margins expanding across all main sectors of the S&P 500 except real estate over the next 12 months. Such margin expansion becomes a tall order if the U.S. launches multiple rounds of import levies.

S&P 500 Composite Index: Profit margins

	2017	2018	2019	2020	12-month trailing	12-month forward
S&P 500	10.5	11.9	12.5	13.2	11.3	12.2
ENERGY	4.1	6.7	7.5	8.1	5.5	7.1
MATERIALS	9.7	11.1	11.8	12.7	10.5	11.5
INDUSTRIALS	8.8	9.8	10.6	11.2	9.4	10.2
CONS. DISC.	7.3	8.0	8.5	9.1	7.7	8.3
CONS. STAP.	7.0	7.5	7.8	8.1	7.3	7.7
HEALTH CARE	9.8	10.4	10.8	11.2	10.1	10.6
FINANCIALS	14.5	18.3	19.1	20.8	16.5	18.7
IT	20.5	22.5	23.0	23.8	21.9	22.8
TELECOM	11.8	13.3	13.5	13.5	12.5	13.4
UTILITIES	11.6	12.2	12.6	12.9	11.9	12.4
REAL ESTATE	20.5	16.2	16.1	16.5	18.2	16.2

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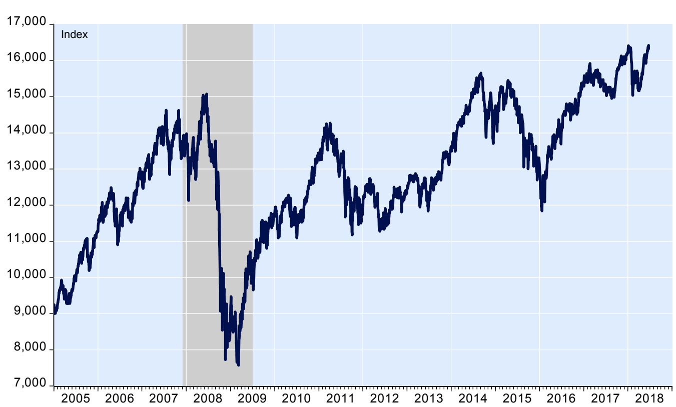
NBF Economics and Strategy (data via Datastream)

Canada: Vulnerable or not?

The last few weeks have not been easy for Canada-U.S. relations. NAFTA talks that recently seemed on the verge of success have collapsed. Yet renewed uncertainty did not prevent the S&P/TSX from closing at a new high on June 20 (chart).

Canada: How much more upside?
S&P/TSX



NBF Economics and Strategy (data via Datastream)

At this writing the bottom-up consensus of equity analysts expects profits to expand 11.9% over the next 12 months (table). This expectation, however, does not take into account a possible trade imbroglio in a critical sector of the economy. President Trump has issued a stark warning of a possible 25% tariff on auto imports from Canada. In a special report published earlier this year, we highlighted that auto and parts manufacturing is the Canadian industry most exposed to U.S. protectionism. In Ontario, where it is concentrated, 2.6% of all jobs and 3.1% of provincial GDP is exposed to its exports to the U.S. (second table, below).[1]

S&P/TSX composite index: EPS Performance

	2017	2018	2019	2020	12 months forward
S&P TSX	28.9	12.5	11.5	10.0	11.9
ENERGY	303.2	27.6	18.9	7.5	22.7
MATERIALS	66.7	18.0	15.5	12.0	16.6
INDUSTRIALS	15.9	8.9	16.9	14.5	13.1
CONS. DISC.	15.1	18.0	12.0	11.1	14.9
CONS. STAP.	11.7	12.9	13.4	11.8	14.4
HEALTH CARE	-29.6	-8.9	30.6	20.4	7.7
FINANCIALS	15.4	8.8	7.3	8.9	7.5
BANKS	10.4	10.5	5.7	8.8	7.2
IT	12.3	17.3	15.2	12.8	13.1
TELECOM	3.6	7.9	4.6	7.8	6.2
UTILITIES	-10.1	17.3	14.1	13.2	23.3
REAL ESTATE	28.0	-6.5	3.7	31.4	-1.6

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NBF Economics and Strategy (data via Datastream)

Canada: Considerable exposure of jobs to automotive exports to U.S.
Exposure of Canadian employment to U.S. protectionism

Table 2 - Employment exposure to industry Canadian exports to U.S.
(Employment dependent on specific Canadian industry exports to the U.S. as a % of total employment - 2013)

Exporting industry	CA	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC
A - U.S. Protectionist rhetoric											
111 - 112 Crop and Animal Production	0.3%	0.0%	0.6%	0.1%	0.3%	0.1%	0.2%	0.7%	1.0%	0.4%	0.3%
3115 - Dairy Products Manufacturing	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
321 - Wood Product Manufacturing	0.3%	0.0%	0.0%	0.2%	0.9%	0.4%	0.1%	0.2%	0.2%	0.2%	0.9%
326 - Plastics and Rubber Products Man.	0.3%	0.0%	0.0%	0.9%	0.2%	0.4%	0.4%	0.3%	0.0%	0.1%	0.1%
3311 - Iron, Steel mills, Ferro Alloy Man.	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.1%	0.0%	0.0%	0.0%
3312 - Steel products from purchased steel	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.0%	0.1%	0.0%	0.0%
3313 - Alumina and Aluminum prod. & proc.	0.1%	0.0%	0.0%	0.0%	0.0%	0.4%	0.1%	0.0%	0.0%	0.0%	0.0%
3315 - Foundries	0.0%	0.0%		0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
335 - Electrical equ., appliance and comp. man.	0.1%	0.0%	0.0%	0.0%	0.0%	0.1%	0.1%	0.1%	0.0%	0.0%	0.1%
3352 - Household Appliance Man.	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
3361 - Motor Vehicle Manufacturing	0.9%	0.2%	0.2%	0.2%	0.3%	0.4%	1.8%	0.4%	0.2%	0.3%	0.3%
3362 - Motor Vehicle body and trailer man.	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.0%	0.0%	0.0%
3363 - Motor vehicle parts manufacturing	0.4%	0.0%	0.0%	0.0%	0.1%	0.1%	0.8%	0.1%	0.1%	0.1%	0.1%
3364 - Aerospace product and parts man.	0.2%	0.0%	0.6%	0.3%	0.0%	0.5%	0.1%	0.5%	0.0%	0.0%	0.1%
Sub-total	**2.8%**	**0.4%**	**1.6%**	**1.9%**	**1.8%**	**2.5%**	**4.1%**	**2.4%**	**1.8%**	**1.2%**	**1.8%**

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If such a blow to the automotive sector occur, it means that the relationship between the two neighbours has turned sour and this would affect the Industrial and Consumer Discretionary sectors of the S&P/TSX. Both sectors have ridden Canadian-dollar weakness to record highs in recent weeks.

[1] See our Special Report, "Reality check: Canadian exposure to U.S. protectionism," March 28, 2018.

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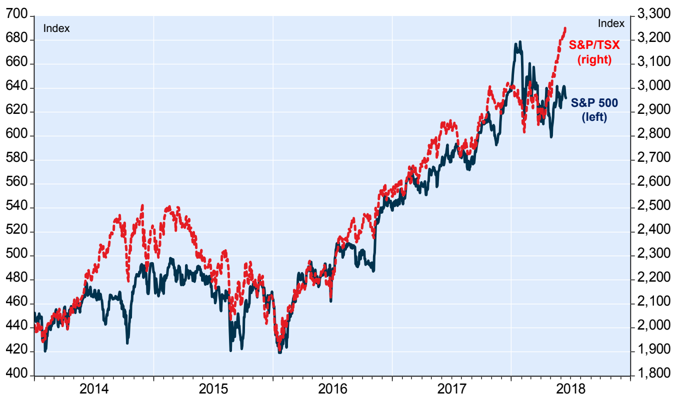
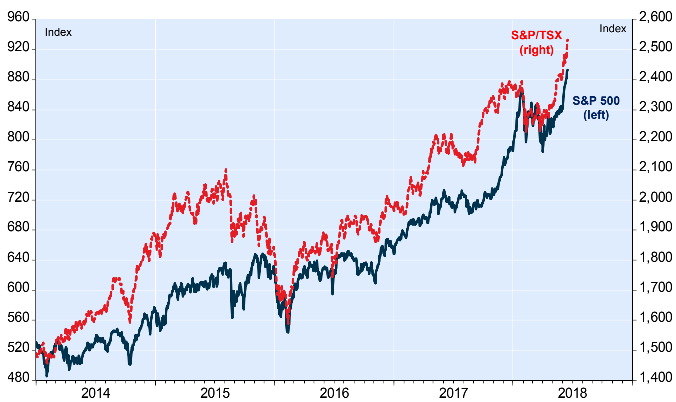
Canada: Industrials at a record high despite NAFTA
S&P/TSX Industrials vs. S&P 500 Industrials



NBF Economics and Strategy (data via Datastream)

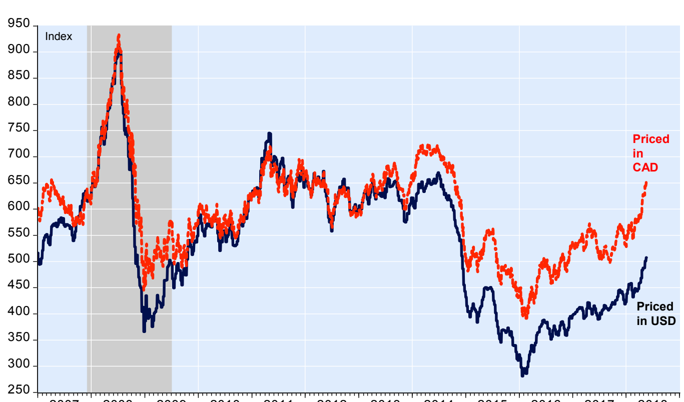
Canada: Consumer Discretionary at a record high despite NAFTA
S&P/TSX Consumer Discretionary vs. S&P 500 Consumer Discretionary



NBF Economics and Strategy (data via Datastream)

Also to be kept in mind is that an escalation of trade tensions between the U.S. and China could strengthen the USD globally, undermining demand (and prices) for commodities produced in Canada.

Canada: A less certain outlook for commodity prices
BoC commodity price index of 26 commodities produced in Canada



NBF Economics and Strategy (data via Datastream)

Asset allocation

Escalating trade tensions prompt us to change our asset mix recommendation. We are reducing our equity exposure by three percentage points in favour of cash. The S&P/TSX has done well in recent months and is closing in on our year-end target of 16,700. Though a weaker Canadian dollar will buoy earnings in a number of sectors, there is a limit to what the exchange rate alone can achieve if U.S. trade policy turns more aggressive on Canadian products (Canada-U.S. trade is a whopping US$630 billion in each direction, i.e. more than U.S.-China trade). Foreign affairs minister Chrystia Freeland last week vowed to undertake a “real push” for a NAFTA agreement over the summer. Since we are skeptical of the minister’s ability to deliver an agreement and since much good news is already priced into Canadian equities, we think a more defensive stance is justified.

U.S.: Volatility is very low considering geopolitical uncertainty
CBOE VIX for S&P 500

NBF Economics and Strategy (data via Datastream)

Uncertainty about trade forces us to revise our outlook for the CAD. Previously we saw a move toward 1.20 this summer. In our revised scenario, CAD/USD remains above 1.30 through the third quarter. We are ready to revisit our position when we get more visibility on the geopolitical front.

Sector rotation

We are modifying our sector rotation this month to reflect our more cautious view, reducing our exposure to Energy, Materials (except golds) and Industrials and increasing our exposure to Telecoms, Utilities and Real Estate.

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NATIONAL BANK OF CANADA FINANCIAL MARKETS

NBF Asset Allocation	Benchmark (%)	NBF Recommendation (%)	Change (pp)
Equities			
Canadian Equities	20	20	-4
U.S. Equities	20	20	+3
Foreign Equities (EAFE)	5	8	
Emerging markets	5	3	-2
Fixed Income	45	39	
Cash	5	10	+3
Total	100	100	

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NBF Market Forecast *Canada*			
		Actual	***Q42018 (Est.)***
Index Level		**Jun-20-18**	***Target***
S&P/TSX		16,421	16,700
Assumptions			Q42018 (Est.)
Level:	Earnings *	981	1021
	Dividend	471	491
PE Trailing (implied)		16.7	16.4
			Q42018 (Est.)
10-year Bond Yield		2.18	2.68

** Before extraordinary items, source Thomson*

NBF Economics and Strategy

NBF Market Forecast *United States*			
		Actual	***Q42018 (Est.)***
Index Level		**Jun-20-18**	***Target***
S&P 500		2,767	2,950
Assumptions			Q42018 (Est.)
Level:	Earnings *	145	154
	Dividend	52	55
PE Trailing (implied)		19.1	19.2
			Q42018 (Est.)
10-year Bond Yield		2.93	3.18

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

NBF Fundamental Sector Rotation - June 2018

Name (Sector/Industry)	Recommendation	S&P/TSX weight
Energy	**Market Weight**	**19.2%**
Energy Equipment & Services	Market Weight	0.5%
Oil, Gas & Consumable Fuels	Market Weight	18.7%
Materials	**Market Weight**	**11.7%**
Chemicals	Underweight	2.4%
Containers & Packaging	Market Weight	0.6%
Metals & Mining *	Market Weight	3.0%
Gold	Overweight	5.1%
Paper & Forest Products	Market Weight	0.6%
Industrials	**Underweight**	**10.2%**
Capital Goods	Market Weight	2.6%
Commercial & Professional Services	Underweight	1.8%
Transportation	Underweight	5.8%
Consumer Discretionary	**Underweight**	**5.8%**
Automobiles & Components	Underweight	1.5%
Consumer Durables & Apparel	Overweight	0.7%
Consumer Services	Underweight	1.4%
Media	Market Weight	0.9%
Retailing	Underweight	1.3%
Consumer Staples	**Overweight**	**3.4%**
Food & Staples Retailing	Overweight	2.6%
Food, Beverage & Tobacco	Overweight	0.8%
Health Care	**Market Weight**	**1.3%**
Health Care Equipment & Services	Market Weight	0.2%
Pharmaceuticals, Biotechnology & Life Sciences	Market Weight	1.1%
Financials	**Market Weight**	**33.6%**
Banks	Market Weight	23.1%
Diversified Financials	Market Weight	3.8%
Insurance	Market Weight	6.7%
Information Technology	**Market Weight**	**4.2%**
Software & Services	Market Weight	4.0%
Technology Hardware & Equipment	Market Weight	0.2%
Telecommunication Services	**Overweight**	**4.3%**
Utilities	**Overweight**	**3.4%**
Real Estate	**Market Weight**	**2.8%**

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

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