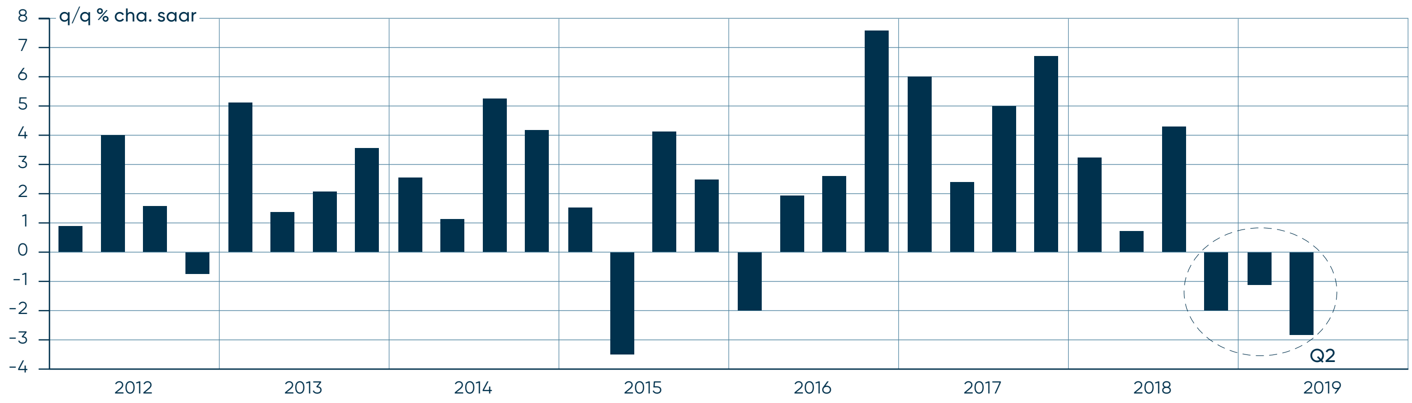
September 2019
Building your financial future

Investment Strategy

World

With de-globalization gaining momentum this year, the deceleration of trade flows and, therefore, world economic growth should not come as a surprise. Things could have been much worse were it not for service-producing industries which, for now, are helping offset the trade-related manufacturing sector slump. While major central banks have taken the opportunity offered by relatively low inflation to loosen monetary policies, that won't be enough to prevent the weakest GDP growth print in years for the world economy in 2019. With central bank stimulus becoming less and less effective, it's difficult at this point to see much of an improvement in 2020, unless of course we see a paradigm shift from world governments, away from growth-restraining policies, such as protectionism, and towards growth-enhancing measures, including major fiscal stimulus and reforms. In light of the escalating U.S.-China trade war, we have lowered our growth forecast for the world economy to 3.1% for this year and 3.2% for 2020.

World: Third consecutive quarterly drop in trade volumes
Global trade volumes



NBF Economics and Strategy (CPB data via Refinitiv)

NATIONAL BANK FINANCIAL
WEALTH MANAGEMENT

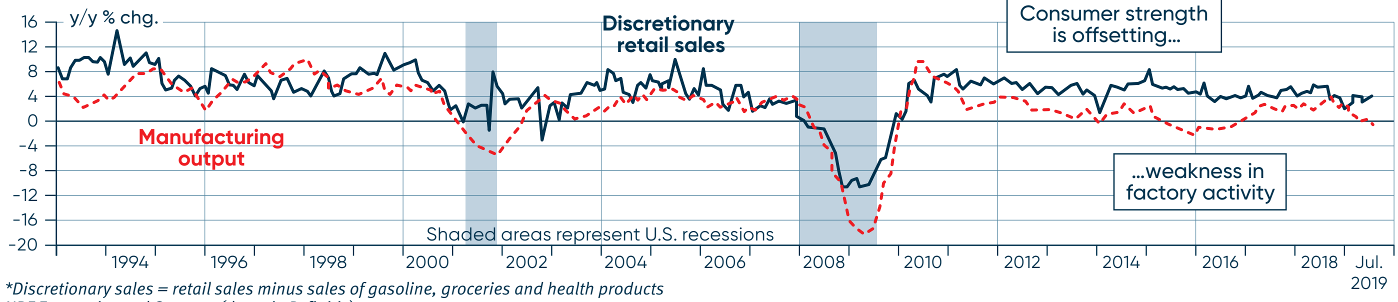
In this issue

United States

The U.S. had a great first half of 2019, according to the Bureau of Economic Analysis, whose annualized estimate of Q2 GDP growth came in at 2.0%, following an unrevised +3.1% print the previous quarter. While inventories and trade provided the expected drag on second-quarter growth, domestic demand offered more than just an offset, as consumption and government spending dwarfed the expected drag from residential investments and non-residential business investments. That's not to say those currently healthy indicators cannot turn bad in the next few quarters. One potential trigger here is destructive government policy—here, we're thinking of the White House's trade war, which is already eating into U.S. corporate profits. Profits from foreign operations have been growing at a snail's pace since tariffs were implemented by the Trump administration. If this becomes a trend, job creation and investment spending are likely to soften. Protectionism-related risks, along with below-target inflation, explain why the Fed is likely to remain in easing mode, despite continued economic expansion and an unemployment rate at an almost 50-year low. We see the U.S. economy expanding 2.2% in 2019 and 1.8% in 2020.

U.S.: Consumers not ready to fold

*Manufacturing output (from industrial production) versus discretionary retail sales**



**Discretionary sales = retail sales minus sales of gasoline, groceries and health products*

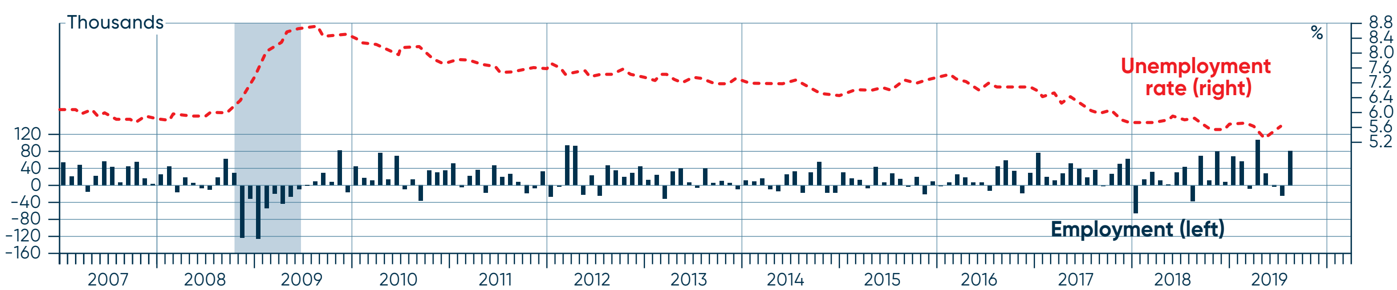
NBF Economics and Strategy (data via Refinitiv)

Canada

After a slow start to the year, Canada's economy bounced back as real GDP growth accelerated sharply to 3.7% annualized in the second quarter. Trade contributed to growth, as exports surged at the fastest pace in five years. Domestic demand subtracted from growth in Q2, but that was entirely due to slumping business investment, which gave back all of the previous quarter's outsized gains. There were nonetheless small gains for consumption spending, government expenditures and even residential investment, the latter contributing to growth for the first time in six quarters. Nominal GDP grew 8.3% annualized, on top of the previous quarter's 5.7% increase, a positive for public finances. All in all, while Q2's stronger-than-expected expansion prompted us to raise our 2019 GDP growth forecast to 1.6%, the darkening global economic outlook casts doubts about commodity prices and, therefore, Canada's prospects for 2020, so we have accordingly lowered our 2020 growth forecast to just under 1.7%. The latter is within the Bank of Canada's range of estimates for potential GDP growth, meaning that the output gap should not open up materially if our forecasts pan out. With near-record-low unemployment and the annual inflation rate near its 2% target, there's not much of a reason in our view for the central bank to replicate all of the Fed's upcoming interest rate cuts, unless of course global financial conditions deteriorate from here.

Canada: Employment bounced back strongly in August

Employment and unemployment rate



NBF Economics and Strategy (data via Statistics Canada)

Investment Strategy

Global risk assets remained volatile throughout the third quarter, unnerved by the introduction of new tariffs from both China and the United States, as well as a series of weak economic data, particularly from Europe. Additionally, this backdrop of heightened uncertainty triggered a bond market signal that has historically preceded recessions: a decline in U.S. Treasury 10-year yields below their 2-year counterpart, known as a "yield curve inversion." Despite this, damage remains somewhat limited, with North American equity indices showing great resilience over the last few months, but many investors wonder whether the worst is yet to come.

Of course, there are valid reasons to discount the red flag from the bond market. For instance, we've never had a recession without first going through a period of restrictive monetary policy, which we arguably haven't undergone yet. Moreover, our analyses show that the factors responsible for the bulk of the decline in long-term U.S. interest rates are not ones we typically see ahead of an economic downturn. We should also remember that those who have exited risk assets at the first sign of an inversion have historically paid an opportunity cost by being on the sidelines far too early. That said, we are mindful not to fall into the "this time is different" trap, which is why we take the yield curve signal for what it is: an imperfect yet compelling call for extra caution. This is all the more true at a time when the direction of the global economy is largely dependent on an increasingly unpredictable geopolitical backdrop.

Yet, these are all reasons why we've already reduced risk in our asset allocation this year, reaching neutrality between stocks and bonds back in May. For us to add another layer of defense, we would need to see further weakness from economic fundamentals, which remain sound as a whole at this juncture. On the other hand, we stand ready to add to our equity positioning, should excessive fear create opportunities, or should the cloud of uncertainty born from the Sino-American trade war begin to dissipate.

Geographically, we continue to favour North American equities over their international peers. As we initiated this positioning, our basic thesis was that the Canadian market's lower volatility and lower valuation made it an attractive alternative in the current tense context, while the more volatile U.S. stocks should ultimately benefit from a resilient economy and flexible central bank. In contrast, growth in Europe and emerging markets seems more likely to suffer in an environment where global trade is under pressure. This outlook proved to be accurate and remains part of our base case scenario.

Turning to currencies, we note that the vagaries of conflicts between Washington and Beijing have also weighed on the Canadian dollar, due to its close relationship with commodity prices and global growth. Fundamentally, however, Canada's strong economic performance should continue to support the loonie, as we expect this backdrop to incline the Bank of Canada to keep its already-accommodative policy rate unchanged, in contrast to rate cuts foreseen south of the border.

MODEL PORTFOLIOS

Portfolio	Asset Class	Minimum/ Maximum	Benchmark	Recommended Weighting	Change from Previous Quarter
Income Portfolio					
Investor Profile: You want to preserve your capital or establish a source of periodic income to finance ongoing expenses. You do not find the stock market very attractive because of its volatility, but you are not against the idea of investing a small part of your portfolio in stocks, mainly to counteract the effects of inflation. Your tolerance for risk is low.	Cash equivalents	0% to 20%	5.0%	5.0%	0.0%
	Fixed income (duration: 6.2 years)[1]	60% to 100%	70.0%	69.0%	0.0%
	Canadian equities	0% to 30%	8.0%	9.0%	0.0%
	U.S. equities		8.0%	9.0%	0.0%
	Foreign equities		4.0%	3.0%	0.0%
	Alternative investments[2]	0% to 20%	5.0%	5.0%	0.0%
Conservative Portfolio					
Investor Profile: On the whole, you want your portfolio invested in fixed-income securities. Although you can tolerate limited volatility to ensure that your assets will grow, you prefer having a portfolio consisting mainly of fixed-income investments for reasons of stability. Your tolerance for risk is low.	Cash equivalents	0% to 20%	5.0%	5.0%	0.0%
	Fixed income (duration: 6.2 years)[1]	45% to 80%	55.0%	54.0%	0.0%
	Canadian equities	20% to 45%	14.0%	15.5%	0.0%
	U.S. equities		14.0%	15.5%	0.0%
	Foreign equities		7.0%	5.0%	0.0%
	Alternative investments[2]	0% to 20%	5.0%	5.0%	0.0%
Balanced Portfolio					
Investor Profile: You give equal importance to achieving growth in your investments and receiving income. You can tolerate moderate changes in market value to ensure growth, but you prefer having a mix of fixed-income investments and equities for reasons of stability.	Cash equivalents	0% to 20%	5.0%	5.0%	0.0%
	Fixed income (duration: 6.2 years)[1]	30% to 65%	40.0%	38.0%	0.0%
	Canadian equities	30% to 65%	18.0%	20.0%	0.0%
	U.S. equities		18.0%	20.0%	0.0%
	Foreign equities		9.0%	7.0%	0.0%
	Alternative investments[2]	0% to 25%	10.0%	10.0%	0.0%
Growth Portfolio					
Investor Profile: Your main goal is capital growth. Although you can tolerate greater volatility in order to increase the value of your assets, you are not prepared to invest your entire portfolio in stocks. Your tolerance for risk is high.	Cash equivalents	0% to 25%	5.0%	5.0%	0.0%
	Fixed income (duration: 6.2 years)[1]	20% to 45 %	30.0%	29.0%	0.0%
	Canadian equities	40% to 75%	22.0%	23.5%	0.0%
	U.S. equities		22.0%	23.5%	0.0%
	Foreign equities		11.0%	9.0%	0.0%
	Alternative investments[2]	0% to 25%	10.0%	10.0%	0.0%
Maximum Growth Portfolio					
Investor Profile: You want to maximize the eventual return on your capital by investing all or most of your portfolio in the stock market. In doing so, you accept higher volatility of your investment returns in the hope that these returns will ultimately be higher. Your tolerance for risk is high.	Cash equivalents	0% to 30%	5.0%	5.0%	0.0%
	Fixed income (duration: 6.2 years)[1]	0% to 30%	15.0%	14.0%	0.0%
	Canadian equities	55% to 100%	26.0%	27.5%	0.0%
	U.S. equities		26.0%	27.5%	0.0%
	Foreign equities		13.0%	11.0%	0.0%
	Alternative investments[2]	0% to 30%	15.0%	15.0%	0.0%

1 FTSE TMX Canada Universe Index
2 Includes Hedge funds, global infrastructure and gold

FORECAST

			Forecast	
	2017	2018	2019	2020
Gross Domestic Product %				
Canada	3.0	1.9	1.6	1.6
U.S.	2.4	2.9	2.2	1.8
Inflation %				
Canada	1.6	2.3	2.1	2.2
U.S.	2.1	2.4	1.9	2.3

	September 2019		December 2019		December 2020	
	Canada	U.S.	Canada	U.S.	Canada	U.S.
Rate %						
Short-term rates (T-Bills, 91-Day)	1.68	1.68	1.71	1.60	1.89	1.59
10-year bond yields	1.19	1.74	1.41	1.86	2.26	2.18
30-year bond yields	1.40	2.22	1.57	2.32	2.26	2.62
Canadian dollar	US $0.76		US $0.77		US $0.74	