



# TACTICAL ASSET ALLOCATION VIEW

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*Don Rich and his team provide MFC GIM investment professionals around the world with insights and information on a wide range of issues and subjects that may affect the global markets, focusing largely on the near term. These insights, however, do not dictate investment policy nor do they represent a "house" view.*

The tactical risk outlook has been made murky by recent better-than-expected U.S. manufacturing data. Two months of gains in an index of new manufacturing orders by the Philadelphia branch of the U.S. Federal Reserve, and an uptick in the ISM's measure of new orders net of inventories, suggest the manufacturing recession that we have been anticipating may at least be delayed. We still think it's going to happen, though. Firstly, the Philadelphia Fed index is notoriously volatile. Secondly, manufacturing is being almost entirely supported by an inventory replenishment cycle that looks increasingly long in the tooth and unsustainable. (While it's possible to see rising inventories as a leading indicator of rising consumer demand, it may also simply reflect the "Wal-martization" of the economy in which companies must order large volumes and then attempt to compete on price. This latter phenomenon left firms with huge unsold inventories during the 2001 and 2008 recessions.)

The indicators that we watch continue to support a defensive tactical position. Our main measure of tactical risk – a composite of sentiment and volatility indicators – continues to deteriorate. It would look worse still if the CBOE Volatility Index (VIX) weren't reflecting an unusually high level of complacency in the face of a renewed European sovereign debt crisis.

The Fed's latest quantitative easing program ("QE2") is also injecting huge liquidity into some global asset classes, raising the risk of speculative bubbles.

Our main economic cycle indicator continues to reflect a slowing economy. Economic surprise is turning from positive to negative as growth continues to slow in every one of the 28 countries in our composite. While the pace of the slowdown may be easing in some countries, it can take the better part of a year for the down cycle to end and economic growth to start accelerating again.

We continue to use relative asset performance to move up the capital structure and better insulate our portfolios against downside risk.

**Fixed Income:** There is very little we like about this asset class. Leaving aside the issuers at the centre of the Eurozone's sovereign debt crisis, most sovereign debt is overvalued and vulnerable to a sharp pullback at the first hint of a shift in currently accommodative global monetary policy. In credit, investment grade issuance looks less frothy than high yield.

**Equities:** We feel safer in value and income stocks than in growth. Geographically, North American stocks are expected to continue benefiting from a recent rebound in the U.S. dollar, with the Canadian dollar holding its own against the greenback. European equities are expected to be hurt by deteriorating credit conditions, austerity measures and jitters about the euro's survival.

**Emerging Markets:** Our defensive positioning favors developed over emerging markets. These markets also face potentially growth-unfriendly consumer inflation triggered by the speculative gains in global commodity prices. Commodities weigh more heavily in emerging market consumer price indices than they do in developed markets.

**Commodities:** There are signs that the speculative bubbles that appear to have formed first in sovereign debt and then in high yield and emerging market bonds may now be forming in commodities like copper as U.S. quantitative easing pushes massive liquidity into these markets.

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