Here's What We're Thinking

Global Portfolio Advisory Group

The Investment Committee of the Portfolio Advisory Group meets regularly to formally discuss markets, sector allocation and investment recommendations. Below is a brief synopsis of our current views. For specific investment strategy relating to your investment portfolio, please contact your Scotia Wealth Management advisor.

Investment Strategy: Markets reach new highs on improving fundamentals

• **Strategy:** Global equities, commodities and bond yields trended higher over the past month on encouraging economic data and earnings reports. In particular, manufacturing surveys, GDP data and labour market numbers have remained consistent with a solid pace of economic activity that continues to trigger ongoing upward revisions to growth forecasts. In the ongoing third-quarter reporting season, U.S. earnings and sales results continue to outperform analyst consensus estimates with earnings per share (excl. the insurance sector) growing at a very healthy 7.4% y/y rate, in large part thanks to stellar results from mega-tech companies. Markets have a litany of event risk to manage through over coming weeks including awaiting U.S. President Trump's nomination of the next Chairperson of the Federal Reserve, Congress introducing a long-awaited tax reform proposal (talk of phasing in corporate tax cuts has weighed on equities recently), a possible ramping up of NAFTA headline risk heading into early 2018 as termination threats linger, etc. Central banks will likely figure prominently as well, with the Fed likely to affirm its intention to hike rates in December while the odds of the Bank of Canada doing the same look to be diminishing following a recent string of weaker data. We stick with our long-held strategy of overweighting equities / underweighting bonds with a bias toward cyclical sector exposure as economic fundamentals remain solid and recession risks for the coming 12 months are quite low.

• **Equities:** Despite near term USD strength, we remain bullish on equities and prefer overweights in Canada, Europe and Emerging Markets at the expense of the U.S. Our new Japan overweight, noted in the last edition of this publication, is off to a good start and we believe the Japanese market is beginning to outperform on improving global demand, tight domestic capacity and ample liquidity. In the short term, our Japan overweight recommendation should be buoyed by receding North Korean tensions, favourable local fund flows (selling foreign bonds in favour of domestic equities as yields rise), and improving Japanese economic data.

• In the U.S., earnings season is past its midpoint and Q3'17 blended earnings growth has slowed to 4.7% y/y. The lower growth rate is due to a $6.9B decline in insurance company earnings related to hurricane catastrophe damage. Excluding insurance from the index, the blended earnings growth rate for the S&P 500 would jump to 7.4%. The blended revenue growth rate for the S&P500 in Q3 currently stands at 5.7%. The twelve month bottom-up target price for the S&P 500 is 2771.94, which implies approximately 8% price return potential based on the recent closing level.

• Some price consolidation is possible in the mid-November timeframe but otherwise we believe global equity markets are poised to close the year higher. We are buyers of pullbacks but believe they will remain of single digit magnitude, potentially disappointing investors underweight equities.

• **Fixed income:** Despite the Bank of Canada's dovish tone, credit continues to perform well. Government yields in Canada have moved lower over the past two weeks following the recent Bank of Canada rate announcement. While keeping the overnight rate unchanged, the Bank

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expressed a "cautious" approach to future rate changes which reduced market expectations for future increases. Despite the caution, corporate credit remains well bid. In fact, most major sectors of the Canadian corporate credit market saw spreads close 1-3bps over the last week. However, one sector that lagged was subordinated debt from insurance issuers. As this is consistent with our cyclical overweight recommendation, we would suggest reinvesting maturities in this sector.

• **Preferreds**: After a strong first two weeks in October, performance of the S&P/TSX Preferred Share index waned as yields retreated from recent highs. Remarks last week from the Bank of Canada (BoC) had an apparent cautious tone, an indication to the market that the Bank of Canada is not in any rush to hike rates further at this time. Yields have been on a one-way path lower since last Wednesday, reducing the implied probability of a December, 2017, rate hike from near 45% prior to the release of the BoC policy statement to around 22% today. A further pull-back in yields is likely to cause some near-term weakness in the preferred share market. The cautious tone from the BoC suggests a near-term pause in the bank's tightening cycle in order to assess the overall impact of the previous two rate hikes, but the longer-term bias remains a further reduction in monetary policy stimulus. Our medium-term outlook for rate resets, our favoured segment of the preferred share market, remains optimistic based on our assumption interest rates are headed higher over the medium-term.

***Currencies and Commodities:* WTI crude oil approaching year-to-date highs; CAD coming off recent highs**

• The price of WTI crude oil is quickly approaching its highs for the year set in late February as investors begin to price in a greater likelihood that OPEC+ production cuts may extend beyond March 2018. Russian President Vladimir Putin and Saudi Arabian Crown Prince Mohammed bin Salman have both publicly backed an extension of the cuts ahead of the OPEC meeting on November 30. In other news, OPEC's Monthly Oil Market Report for October, which was released this morning, showed an increase in the organization's world oil demand forecast for 2017 of 30,000 barrels per day (bpd), as well as a 100,000 bpd reduction of its world oil supply forecast for 2017. OPEC also increased its 2018 world oil demand forecast on the back of the improving economic outlook for the world economy, particularly in China and Russia. In our view, the fundamental backdrop for crude oil remains constructive and we expect the rebalancing process to continue into 2018.

• Despite the strength in crude oil, the Canadian dollar has come off its highs for the year, declining ~6% against the U.S. dollar since September 11. In our view, the movement in the CADUSD over the last year has been more a result of monetary policy divergence between Canada and the U.S. than movements in crude oil. While the Bank of Canada's decision to leave its policy rate unchanged at 1% last week did not come as a surprise to the market, the more cautious tone by the BoC may have, with the CAD declining ~2% since the report. The more dovish tone of the BoC, along with the recent string of weaker-than-expected Canadian economic data, may result in downward revisions to CADUSD forecasts, in our view. This may also lower the likelihood of the Canadian dollar reaching the Scotiabank Economics year-end 2018 forecast of US$0.87.

***Economics:* Central banks in major economies on course for cautious monetary policy tightening**

• The Fed appears on track to increase interest rates one last time this year (in December) and continues down its monetary policy tightening path. The U.S. Federal Open Market Committee is meeting tomorrow and no rate hike is expected in this statement-only affair. The consensus expectation is the Fed will increase interest rates at the end of this year, with the Fed funds futures market pricing in an 84% chance of a December rate hike. Meanwhile, the Fed initiated its bond reinvestment reduction plan this month, and the recent strong U.S. Q3 GDP reading and August closure of the output gap further support the Fed's outlook for tighter monetary policy.

• The European Central Bank (ECB) is also on course to tighten monetary policy. The ECB announced last week it will start tapering its quantitative easing (QE) program in January next year. The 19-nation central bank will cut its

monthly bond purchases from the current level of €60bn/month to €30bn/month in January through September of 2018. Despite a tightening bias, the ECB said it could increase the size or duration of its QE program if economic conditions deteriorate, keeping all of its options open.

• Meanwhile, the Bank of England (BoE) will likely raise interest rates from 0.25% to 0.50% on Thursday, and markets are assigning almost a 90% probability of a rate increase this week. U.K. inflation has increased to a five-year high of 3%, supporting the BoE's bias toward hiking rates.

• In Canada, the Bank of Canada (BoC) turned more dovish than previously expected last week as central bankers noted NAFTA renegotiation was a key source of uncertainty. The sensitivity of household spending to interest rate changes is also a concern given current record-high household debt levels. This morning's soft GDP data for August may also dampen the outlook for future BoC rate hikes. In our view, the BoC will most likely remain cautious and stay put for the time being until further signs of economic strength emerge.

***Geopolitical:* Charges laid in Russia probe, which remains a distraction for legislative agenda**

• U.S. politics continues to add noise around Trump administration initiatives. On Monday, the first charges in Special Counsel Robert Mueller's investigations were unsealed and included U.S. President Trump's one-time campaign manager and his aide. The charges were made with the help of a junior foreign-policy adviser to the Trump campaign as a cooperating witness. While these charges – which include conspiracy against the United States, unregistered agent of a foreign principal, and false statements – are not directly related to Russian collusion, they expose the broad scope of the Trump campaign's communication with outsiders. For now, the investigation's reach continues to be a matter of speculation. However, that speculation could lead to in-fighting at the White House and Capitol Hill and create further roadblocks to Trump administration initiatives like tax reform and budget approval.

Recommended Asset Allocation

Asset Class	Strategic	Tactical
Equities	**60%**	**68%**
Canada	30%	33%
United States	25%	28%
International	5%	7%
Fixed Income	**40%**	**30%**
Government	20%	10%
Provincial	5%	5%
Corporate/Credit	10%	10%
Preferreds	5%	5%
Cash	**0%**	**2%**

Sector	Underweight	Neutral	Overweight
Financials			✓
Healthcare			✓
Consumer Staples	✓		
Consumer Discretionary			✓
Industrials			✓
Materials			✓
Energy			✓
Utilities	✓		
Telecom	✓		
InfoTech			✓
Real Estate	✓		

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