

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: Potential of increased near-term volatility; medium-term outlook remains bullish

• **Strategy:** Markets will have to digest a flurry of important event risk and developments over the coming couple of weeks including February U.S. labour data (3/10), a Federal Reserve interest rate policy meeting (3/15), Netherlands' national election (3/15), Pres. Trump's budget submitted to Congress as well as negotiations over debt ceiling (Mar. 16), UK could invoke Article 50 triggering Brexit negotiations & European summit (3/9-10), China NPC & economic policies/targets (3/9), G20 finance officials meeting (Mar. 17-18), and a Trump/Merkel meeting (3/14). Of particular importance, FOMC members have been suggesting that the committee is ready to hike rates next week, a signal that investors' confidence in an improving economy is well-placed (the market has priced in a full rate hike). Strong gains year-to-date across global equity markets and the pipeline of possible volatility-inducing events amidst an environment of rising interest rates could result in temporarily elevated volatility which triggers a modest pullback (2%-5%) across major indices in the near-term. We would view any such weakness as an attractive buying opportunity for long-term investors as recession risks remain low for the coming year. Our strategy continues to emphasize an overweight to equities vs. bonds as well as sector preferences focussed on cyclical/reflation segments (financials, industrials, energy, materials, value, etc.).

• **Equities:** Various calls by market participants for an imminent market correction/crash have largely been ignored by equity markets. Such behaviour, following strong market gains, is indicative of a robust bull-market and we believe this market will continue to climb the "wall of worry" well into 2018. Our bullish outlook started in Q1 of 2016 and was upheld through Brexit and the Trump victory. For the first time in almost a year, we are taking down our bullishness just a notch and only in the near term by postulating a possible 5% correction in the coming weeks. That being said however, we still see strong double-digit returns for global equities this year and would prefer investors already invested to remain constructive and look through any upcoming weakness. Our cautiousness is more targeted for cash sitting on the sidelines that is looking for a new entry point that could elect to be more selective in its near-term entry.

• As more information becomes available we will continuously refine and shape our forecasts accordingly. With that being said, we believe the de-facto U.S benchmark (S&P 500 index, currently trading at 2372 with a trailing PE = 21.6) could post another year of impressive gains on the back of solid consensus earnings growth and minor multiple expansion. We believe with rate normalization and index composition changes, valuation multiples have room to surprise materially to the upside in the coming years. Post-election, we turned to a North American bias over Rest of World which was the correct call (+6% performance difference). However in the meantime, the economic surprise and earnings surprise data for the rest of the world has been much stronger than in North America and has opened up a compelling valuation gap. We believe the time has come to seriously consider taking up our



Enriched Thinking™

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international weight in the portfolio to go along with our reflation bias (Banks and Energy) with select thematic stories preferences such as Defense, Engineering, Heavy Construction, Chemicals, Homebuilders, Biotech&Pharma, Travel&Tourism, Semiconductors, and Computer Hardware to name a few.

- **Fixed Income:** As expected, the Canadian corporate bond market is starting to show signs of a repricing. Over the past two weeks, A-rated spreads have continued to tighten, albeit at a slower pace. BBB-rated spreads on the other hand have levelled off completely. This has caused the BBB/A spread to widen, indicating the first signs of risk off moves in the Canadian dollar corporate market we have seen in some time. This is expected given BBB spreads are much tighter than the 5-year average compared to A spreads. Additionally, U.S. yields have risen over the past couple of weeks as a Fed Funds rate hike on March 15th was priced into yields. As usual, this puts upward pressure on Canadian yields and those corporate markets with less room for spread compression would be expected to react first. We wrote in our last edition – and reiterate now – we wouldn't be surprised by a correction in corporate spreads and would be purchasing if this materializes. We continue to be encouraged by the closing of the output gap and accommodative monetary policy despite the beginnings of “normalization” by the U.S. Federal Reserve.

- **Preferreds:** The preferred share market has been modestly lower over the last couple of weeks alongside volatile underlying interest rates. Over the last two weeks, the S&P/TSX Preferred Share Index fell 0.83% on a total return basis led lower by rate reset preferreds. Rate resets as represented by the Solactive Laddered Total Return Index declined 1.05% over this same time period. Although Government of Canada 5-year bond yields are relatively flat on a two week basis, yields have been quite volatile in this time period falling approx. 8bps to below 1.10% before recovering back to the 1.16%-1.17% range. We expect price volatility to persist in the market alongside movements in underlying bond yields. We still see the greatest opportunity in rate resets with the expectation of higher future bond yields. We prefer to be positioned in longer-dated rate resets as we see a great benefit in having a longer-time horizon

to reset in order increase the likelihood of receiving higher dividend rates upon extension than if reset at rates today. A rising yield environment also should help to drive credit spread improvement and thus lower risk premiums in many industries; specifically Financials and Energy, both of which comprise a large percentage of the overall market.

Economics: Fed: March rate hike is on the table!

- While investors are left hanging as details of Trump's new policies remain unclear, they are quickly gravitating to consensus view that the Fed is ready to make a move very soon. It seems like the central bank is moving ahead of the politicians this time to avoid the possibility of an overheating economy. Many Fed officials have adopted a more hawkish tone in recent days as economic indicators have shown consistent signs of growth in the U.S. economy as well as in Europe and Asia. Probabilities of a March rate hike priced into Fed Funds futures have climbed quickly in the past two weeks, from 30% to as high as 80% just before Yellen's speech last Friday. At her speech in Chicago, the Chair indicated that the central bank believes that “it will be appropriate to gradually increase the federal funds rate if the economic data continue to come in about as we expect”. She also commented that the committee will evaluate whether employment and inflation are still in line with the Fed's expectations at the FOMC meeting on March 14th & 15th, and a further adjustment of the Fed Funds rate could be appropriate if that is the case. The probability of a March rate hike rocketed to 96% after Yellen's speech and the Fed has made it loud and clear that a rate hike is coming soon. In terms of the path of rate hikes for the rest of 2017, Yellen has also signaled that if the economy picks up more momentum this year, the central bank may need to raise rates at a faster pace. Keep in mind that February readings of the U.S. labour market including nonfarm payrolls, the unemployment rate and wages will be released on Friday. If this flow of labour market data turns out more or less in line with expectations, it is increasingly likely an interest rate hike could materialize on March 15th.

Currencies and Commodities: Good value in oil equities; copper market continues to tighten.

- Crude oil futures and options investors decreased net long positioning by approximately 3% last week, an indication investors may becoming less bullish on the commodity. Headlines suggested Russia is not keeping its side of the supply-cut bargain with OPEC, and Nigeria said it plans to increase production to levels not seen since militant pipeline activity severely decreased output capacity. WTI finished the week ~1.2% lower, while Brent's losses were more muted at just 0.2%. At the CERAWEEK energy conference in Houston this week, however, Russian energy minister Alexander Novak said his country would satisfy its commitment under the deal (reducing oil production by 300,000 bpd) by the end of April, noting Russia has so far cut production by about half that amount. Oil continues to trade in relatively range-bound fashion but energy equities remain depressed. The S&P/TSX energy exploration and production index is down 10% YTD through 03 March/2017 and oil-weighted producers continue to represent some of the best value in the equity markets, in our view. North American natgas prices and related equities have faced a tougher start to 2017 owing to a warmer-than-expected winter.
- Within the base metals complex, we remain constructive on the copper market. Heightening

disruptions, notably at the Escondida and Grasberg mines (which collectively represent ~10% of global supply), are on pace to tip the copper market into its first deficit position since 2010 and represent upside risk to copper prices. Potentially adding to tightness in the copper market was news yesterday that workers at the world's number three copper mine, Cerro Verde, plan to start a five-day strike this Friday. However, a representative for the workers' union and the mine's controlling owners said the strike could be indefinite.

Geopolitical: U.S. tax plan raises potential concerns

- The U.S. tax plan being pitched by Paul Ryan could put pressure on the already weak retail industry. The retail industry is coming off yet another soft Q4 where online providers have taken more market share. The House Speaker's tax plan proposes a border adjustment tax which would tax sales, rather than profit, and putting those retailers who import more goods at a disadvantage. However the tax deal isn't approved yet, as there remains a significant contingent within the Republican Party that is opposed to the plan. Regardless of the final presentation, if a border adjustment tax is levied, and aimed at goods from specific countries, this could spark retaliation and raise concerns of a trade war.

Recommended Asset Allocation

Asset Class	Strategic	Tactical
Equities	60%	68%
Canada	30%	33%
United States	25%	30%
International	5%	5%
Fixed Income	40%	30%
Government	20%	10%
Provincial	5%	5%
Corporate/Credit	10%	10%
Preferreds - Rate Reset	5%	5%
Preferreds - Fixed Perpetual	0%	0%
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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None.

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None

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