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: ***Economic data remains rosy; Summer volatility possibly ahead***

• **Strategy:** As global markets close the door on the month of May we find equities handily beat bonds (U.S.: +1.5% vs +0.3%; Europe: +4.5% vs +1.7%) despite a spike in volatility on the back of political noise out of Washington. However, in Canada, risk aversion dominated, leaving stocks (-1.3%) lagging bonds (+0.7%) on the back of growing global investor concern over recent headlines highlighting domestic housing/debt/financial sector pressures. While Canada's underperformance relative to other global markets should unwind itself in coming weeks/months, a pending kick-off of talks to renegotiate NAFTA could maintain bouts of volatility for some time yet. On the economic front, indicators suggest the pace of activity globally has remained solid through the first five months of 2017, benefitting from a rebound in business investment and healthy employment growth. As a result, we see global GDP growth holding near 3% (the top end of this cycle's range) leaving recession risks over the coming year quite low. Thus, our asset allocation approach remains biased toward equities over bonds within a medium-term investment strategy. However, we believe momentum within equities has waned alongside a deterioration in the breadth of sectors supporting recent market gains. Thus, we advise some caution in putting new money to work at the current time amidst a turn in seasonal pressures that could result in elevated volatility over coming months.

• **Equities:** We recommend caution in putting new money to work but remain over-weight equities in anticipation of a 3%-7% spring-summer correction. Our strategy is to seek out less expensive stories by lightening up on the U.S. and moving that exposure to Europe. We continue to believe European equities could close the valuation gap as previous headwinds (inflation, negative banking sentiment, political risks, Euro break-up fears) switch over to tailwinds (GDP, PMI, and business/consumer confidence, benign USD). Europe and other International regions stand to benefit from potential U.S. equity outflows as positive economic surprises continue apace and market participation in the U.S. continues to narrow on every new high. Long-term we remain equity bulls.

• Another area where we see opportunity is the Energy sector as many parts have already corrected by more than a third and oil fundamentals continue to improve. With sentiment souring and investors losing patience, the second half of the year could see a mean reversion opportunity (like Nasdaq in 2H'16) which could prove to be favorable for Oil, Energy and Canada - stay tuned.

• As for a Q1 earnings summary, through May 30th, 98% of the companies in the U.S. have reported and year-over-year earnings and revenue growth stand at a healthy 14% and 8%, respectively. Earnings topped already high expectations heading into the quarter as 75% of companies have beaten expectations versus an average of 66% since the 2009 start of the bull market. In Canada 94% of companies have reported and year-over-year growth stands at 43% for earnings and 10% for revenues.

• **Fixed Income:** Risk off and repricing have continued to dominate the Canadian fixed income market. Canadian government bonds have benefitted from global risk-off trends over the last two weeks and that has influenced the corporate and provincial markets. Over the past two weeks the provincial sector outperformed corporates. The cause of this is likely two-fold as markets continue to correct tight yields and absorb new corporate issues. As we have stated in the past we believe this correction is warranted given the outperformance of corporate bonds over the past 12-16 months. We continue to believe the corporate sector will outperform over the next 12 months as monetary policy remains accommodative. At this point we would remain on the sidelines until this correction fades, at which point we would deploy cash into the corporate market.

• **Preferreds:** The weakness in the preferred share market has followed a similar path to the Canadian equity markets throughout May. The S&P/TSX Preferred Share Index has underperformed the TSX this month declining approx. 2.05% as of Monday's close. Rate resets/fixed floaters have been the worst performing type of preferred share in May followed by floating rate preferreds, while straight perpetuals have outperformed. However, on a year to date basis, floaters are the clear winner (up approx. 9%) with rate reset/fixed floaters following behind (up approx. 5%) with fixed perpetuals lagging the group (up approx. 4%). Although we have become slightly less hawkish on our near-term outlook for yields, we still believe yields are biased higher over the medium term. Our medium term outlook for yields supports our recommendations for purchasing longer dated rate resets. Holding longer dated resets allows additional time for our thesis to play out before the security approaches its reset date.

***Currencies and Commodities:* Production agreement extension could prove constructive for crude**

• Last Thursday, the 14 OPEC members and ten non-OPEC producing countries announced a nine-month extension (beginning 01 July/2017) to the production agreement they originally struck in late-2016. We believe the extension is constructive for crude oil prices. Analysis by Scotiabank GBM's energy strategist suggests the extension should support supply/demand deficits in global crude oil markets through the first half of 2018, taking into account U.S. production growth and steady global demand growth. Subsequent to the OPEC meeting, crude oil futures sold off, perhaps reflecting expectations amongst some market participants OPEC and its affiliates would act more aggressively. We believe the weakness was short-term in nature and expect crude oil prices to stabilize in the ~US$50/bbl range near-term.

***Economics:* June rate hike penciled in; balance sheet reduction could also be on its way**

• U.S. monetary policy makers continue to see two more rate hikes this year after raising rates back in March and the central bank seems to be ready for more tightening in June. The Fed Funds futures market is pricing in a 100% probability of a rate hike next month, while odds for a third hike in September fell after the release of the FOMC meeting minutes last week that outlined central bankers' plans to start shrinking the Fed's balance sheet. Fed officials generally agreed on beginning to reduce the amount of bonds the central bank holds later this year, which could put rate hikes on hold as the central bank awaits the impact of recent monetary tightening and at the same time cements the specifics of its balance sheet reduction plan. The program will likely include a steady increase in the amount of securities it would roll off each month. With Yellen's term expiring next year, the Fed will likely set up a trajectory for the path of rate hikes and unwinding the balance sheet before the end of the Chair's term. Given balance sheet reduction will likely be underway later this year, we probably won't have another rate hike until after the program is set up. Therefore the probability of a September hike is diminishing and a December hike is looking more likely at this point.

***Geopolitical:* Energy projects under scrutiny following B.C. election result; Congress' August break leaves little room to maneuver**

• The final tally for the British Columbia provincial elections are in and confirmed initial results. The Liberal party remained one seat shy of a majority (43 legislature seats) while the NDP and Green parties won 41 and three seats, respectively. This left the Green party firmly in the driver's seat to form a coalition. Following the results, the Green and NDP parties agreed in principle (subject to NDP caucus approval) to a "Confidence and Supply Agreement" which increases the likelihood of a minority government between the two. The agreement, if it stands, could cast a shadow over energy production and infrastructure in the province. However, some energy infrastructure projects, such as pipelines, are within federal jurisdiction and have already received approval. For a full discussion of energy sector implications, please read *BC Election: It's Not Easy Being Green, Orange or Red…Enter Lieutenant Governor*, published by Scotiabank GBM on May 30.

• Markets remain distracted by noise from Washington. President Trump has recently returned from an international trip where he made headlines on a number of issues including trade, the environment and international relations. He signed an arms deal with Saudi Arabia, deliberated on pulling out of the Paris climate accord and strained relations with Germany. All the while the investigation into possible connections between Trump's campaign and Russia intensified and focused on his son-in-law Jared Kushner. Back at home, Trump's cabinet presented its first budget proposal, which was contested on both sides of the aisle, while the recently confirmed US Trade Representative triggered a 90-day notice ahead of formal NAFTA renegotiation. All of this continues to be a distraction for global markets, which ebb and flow as news breaks. More directly, these distractions take away from the U.S. administration's ability to implement its key initiatives. We continue to follow U.S. political developments closely but with only 35 days left in the congressional calendar before the August break, time is becoming a factor. The aforementioned budget must be approved and the debt ceiling returns to focus in the fall. This leaves little time to tackle healthcare, infrastructure or tax reform before mid-term campaigning begins in 2018 – assuming legal troubles don't further derail the legislative process.

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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None.

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None

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