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:* Summer volatility upon us; healthy sector rotation sets in.**

• **Strategy:** Global markets have generally moved sideways in wide ranges over the past couple of weeks with equity and bond markets largely flat while commodities have slid further as currencies gained in relation to the U.S. dollar. Global economic data trends have remained mostly consistent with forecasts for stronger growth this year, underpinning improved corporate revenue and earnings outlooks. However, a notable exception has been the data flow in the U.S. where recent modest disappointments have led to some marking down 2017 GDP forecasts (including the IMF), resulting in the consensus gravitating to our own house view (2.2%). Central bank policy has also taken centre stage with policymakers in the U.S., Canada, the U.K. and Europe expressing increasingly hawkish biases for the future direction of policy. This has led to some consternation within the market that the Fed may be committing a 'policy error', i.e. hiking too quickly which causes an untimely recession, a view we do *not* subscribe to. As we approach the half-way mark of 2017, global equity markets have notched impressive gains (S&P500 +8.3%) leaving significant profit-taking potential amidst the seasonal headwinds of the summer months and possible complacency given markets haven't experienced a correction in excess of 6% in an unusually long time (since February 2016). Thus, while we remain bullish on the medium-term prospects for global markets given solid fundamentals, in the near-term we advise caution in putting new money to work. Instead, we would view any material pullback in markets as an attractive opportunity for long-term investors.

• **Equities:** We continue to recommend an equity bias over fixed income though advise caution in putting new money to work until we see a pickup in volatility. The sector rotation opportunity we have been highlighting (moving from technology to cyclical sectors such as financials, industrials, energy and materials) is now underway and we believe these trends will continue at the start of Q3 propelled by late portfolio re-balance programs. Despite today's disappointment in the delay of the U.S. health care bill vote, we believe the health care sector offers the best blend of growth, value and investor positioning.

• We see the fundamental backdrop for the economy and corporate earnings remaining strong and believe it is too early to be concerned about overall index valuations. As a testament to the health of this bull market we are encouraged by the market's ability to internally refresh through sector rotation.

• Geographically, we remain overweight international markets versus the U.S. and are encouraged by early signs of improving momentum in the Canadian market as well.

• **Fixed Income:** Cooling data has flattened yield curves. After the Bank of Canada turned hawkish and the U.S. Federal Reserve outlined its plan to reduce the size of its balance sheet, data turned soft causing the Canadian curve to flatten. In fact, the 10yr-2yr spread is at its lowest level since before the U.S. election. Naturally this caused long bonds to outperform. As they have for some time, corporate bonds performed well with repricing of BBB-rated credit leading to A-rated credit outperformance. In a divergence of recent performance, long provincial bonds dominated similar-dated corporate bonds. However this was due to more technical factors like lack of supply and coupon reinvestment. Thus our thesis remains intact that corporates will continue to outperform. Additionally, we remain interest rate defensive and expect the Canadian and U.S. economies to continue to expand leading to increasing yields (and curve slope).

• **Preferreds:** In the last two weeks, the preferred share market has traded relatively flat following close to a 3.00% rally in the overall index the preceding week after both Senior Deputy Governor Wilkins and Bank of Canada Governor Stephen Poloz spoke much more favorably on the outlook for the Canadian economy than previously. This revised outlook sent yields higher with the market since pricing in an implied probability of a potential rate hike of close to 45% by year-end. The recent shift in tone out of the Bank of Canada should support underlying bond yields in the medium-term supporting our preference for rate reset preferred shares. Underlying bond yields are likely to remain sensitive to commentary from central banks globally, which is likely to cause ongoing swings in bond yields and cause further volatility in the preferred share market. Hence, near-term price volatility is likely to continue with a favorable medium-term outlook as yields climb higher. We prefer to position within the rate reset segment of the market, but are warming up to floaters on the recent shift in tone out of the Bank of Canada. However, we remain cautious on the overall floating rate segment due to the reduced liquidity in many of the shares. Accordingly, it is important to consider issue size when looking at this segment.

***Currencies and Commodities:* Are low prices the cure for low prices?**

• WTI crude oil prices rose for a fourth consecutive day following several challenging weeks for the commodity. Press reports suggest recent strength may be tied to a weaker U.S. dollar and investors covering short positions in the commodity ahead of calendar quarter-end this Friday. However, we believe investors remain concerned about elevated global inventories of crude oil and may require evidence of tightening global supply/demand balances to spur further gains. Research from various global investment banks, based on summaries we have reviewed, indicates a sustained period of prices below the US$45/bbl mark may eventually temper U.S. production growth and put a floor beneath the price of crude oil.

***Economics:* Trade negotiations to start soon; China continues to drive down the deleveraging road.**

• Five months after taking office, President Trump is moving forward with his protectionism advocates and starting to take real steps in his trade negotiations. Concerns have risen that the impact of politics on trade and trade agreements could dampen Canada's economic growth outlook, especially after the U.S. Commerce Department slapped a 20% tax on Canadian softwood lumber back in April after Trump said he was only considering "tweaks" to trade rules with Canada. Discussions around duties on steel imports led to another wave of concerns after President Trump ordered a review of U.S. steel imports back in April. The result of those discussions should be known any day now. The U.S. Trade Representative's office has three days of hearings, starting today, with representatives across different sectors. Canada contributed the third largest share of U.S. imports in 2016 after China and Mexico, and major changes to trade deals could have significant impacts on the Canadian economy and the Canadian dollar.

• China continues on its deleveraging path after three months of trying to crack down on financial irregularities. The growth of the broad measure of money supply in China hit a record low in May, growing at single-digit speed, according to the People's Bank of China (PBOC) data. While keeping cash conditions relatively tight, authorities have been careful not to squeeze liquidity too much and aim for a gradual and pragmatic regulatory tightening. PBOC data showed that total social financing (a broad measure of credit and liquidity in the economy) and Chinese Yuan loans provided by Chinese banks both increased on a YoY basis in May, indicating robust financial support for the real economy. Moody's Investors Services downgraded China's credit ratings for the first time in nearly 30 years late last month, which further encouraged China's central bank to pursue its deleveraging path. The PBOC Governor Zhou Xiaochuan expressed his view that "lessons from the global financial crisis showed us that guarding against financial turmoil should start from keeping financial institutions clean and not tolerating high-leverage and bad loan practices". Looking beyond the progress of recent deleveraging measures, possible changes of the Communist Party's leadership later this year could lead to shifts of the party's major focuses and therefore the path of China's economic growth. Note that China's 19th National Congress of the Communist Party will be held this fall in Beijing, five years after the last gathering when President Xi was elected General Secretary. Although Xi is expected to remain in power, some personnel changes are expected in the top decision-making body.

Geopolitical: ***Final dash ahead of summer recess.***

• The Trump administration is garnering attention as the summer recess nears. Amid allegations and U.S. Senate testimony, the Trump administration is trying desperately to get its health care bill passed before the House and Senate break for the summer. The last day before the August holiday is July 28th which leaves only 18 Senate sessions and 16 House sessions. That may sound like a decent amount of time, but the American Health Care Act (AHCA) still needs Senate approval before going back to the House. Considering the Congressional Budget Office recently estimated the Senate bill would leave an additional 22 million Americans uninsured, and the Senate vote was postponed until after the U.S. Independence Day, that process could take some time. Markets are paying attention not only for the direct implications for the health care industry but also for potential tax changes and infrastructure spending; the quicker health care is resolved, the faster the Trump administration can move on to its initiatives to boost the economy. If the AHCA doesn't get resolved before the August break, Congress will run into deadlines for the U.S. budget and debt ceiling, which could further delay the administration's plans.

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.

The supervisors of the Portfolio Advisory Group own securities of the following companies.
None

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