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: Market volatility the new norm; fundamentals remain solid

• **Strategy:** Elevated market volatility has gripped global markets in recent weeks, with the latest bout of selling pressure dragging markets back to the lows of early-February. In this iteration, fears over escalating trade tensions between the U.S. and China and government intervention in the U.S. technology sector are at the centre of market concerns. We see these factors as having a transitory effect on markets. At the same time, we would characterize last year's near all-time low in volatility readings as an aberration and this year's spike in volatility as a return to a more normal volatility environment. This is particularly true in view of the late stage of the economic and market cycle in which we find ourselves, characterized by above-average valuations, rising interest rates, and crowded positioning. The key for investors is the outlook for medium-term global macro and market fundamentals, and on this score we remain bullish. We see global economic growth easing slightly from the red-hot pace of late last year to a still-impressive above-trend pace, thanks to solid employment and income growth and supportive policy settings. This should continue to push unemployment rates lower and inflation rates modestly higher over the rest of the year, in our view. This environment should also support continued double-digit earnings growth over the coming year and keep the risk of a recession over the next 12 months at very low levels. As well, valuation metrics have returned to more attractive levels following the February and March pullbacks. Thus, we maintain our asset allocation strategy of overweighting equities relative to fixed income and preferring cyclical market sectors to defensive ones. We would view any material pullback in markets as an attractive opportunity to deploy significant cash holdings.

• **Equities:** Year-to-date, the equity market's decline can be described as a "tale of two halves". The decline in February saw growth and momentum stocks provide a relative safe haven for investors, whereas the market decline in March saw the same group lead the decline. In our view, this activity provides some evidence of investors rotating their portfolios and booking profits on multi-year winners.

• Over the next several weeks, we expect equity flows to return to positive territory as the market forges a bottom at or near current levels. We will watch with great interest to see if investors return to growth-oriented names or if much-out-of-favour value stocks (including the Canadian S&P/TSX Index) finally "catch a bid" and put together a sustainable rally.

• Since 2000, history shows buying the market during a decline and just ahead of earnings season is, on average, a winning strategy. With the U.S. Q1 earnings season "officially" starting next week, analysts are expecting year-over-year earnings growth of 17.3% and revenue growth of 7.3%. In addition, the 12-month bottom-up price target for the S&P 500 index is 3098, which implies approximately 18% price return potential from current levels. We retain our two-year-old equity overweight call (relative to fixed income) as we recognize the current economic cycle is in its later stages but (in our view) not over yet.

Scotia Wealth Management™ Enriched Thinking™

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• **Preferreds:** Uncertainty has pressured risk markets, with recent investor angst sparked by global trade concerns ranging from U.S. tariff announcements to NAFTA renegotiation unknowns. The sell-off in risk markets has caused a flight-to-safety bias, driving bond yields lower and credit spreads wider. The risk-off environment, coupled with lower bond yields, resulted in a modest dip in the S&P/TSX Preferred Share Index from March 21st through April 2nd (-0.34% price basis) with weakness in rate reset and floating rate preferred shares partially offset by a stronger performance in straight fixed perpetual preferred shares. Over this time period, rate resets have declined 0.39% alongside a 0.74% drop in floating rate preferreds, while straight fixed perpetuals have risen 0.22%. The recent market weakness has been led by lower credit quality issuers, driven by the recent widening in credit spreads. We retain our favorable view of higher credit quality issuers within the rate reset segment, premised on our expectation of higher underlying interest rates over the medium-term and resilient credit fundamentals.

• **Fixed income: Canadian credit product finding an equilibrium.** During the last two weeks, market volatility has dominated rates and prompted selling in credit markets. Spread products, both provincial debt and corporate credit, have underperformed Government of Canada debt at all points on the yield curve. Within corporate credit, energy and financials have underperformed, while spreads on lower-beta real estate and utility debt have held in. Despite the weakness, we continue to believe cyclical sectors will outperform as economic and corporate fundamentals remain supportive. However, we suggest investors looking to deploy new money wait until markets have established an equilibrium before doing so.

Currencies and Commodities:* *Gold shines bright; trade remains central issue in global foreign exchange market

• Gold has had a solid start to 2018, with the commodity up nearly 3% year-to-date, despite higher interest rates and global economic data that remains solid (and typically results in economic optimism). So what is behind gold's outperformance relative to equity markets? In our view, a heightened level of market volatility that investors have not experienced in some time is likely offsetting the gold headwinds mentioned earlier. The increased level of volatility has, in our view, been driven by an aggressive year-to-date move higher in bond yields, global trade-related concerns, and the fact that we are in the midst of the second-longest economic expansion in the post-World War II era. However, given our expectations of only moderate downside in the U.S. dollar from current levels, rising real interest rates, and generally higher equity markets by year-end, we believe further upside in the price of gold could be limited.

• In recent testimony before the U.S. House Ways and Means Committee, U.S. Trade Representative Robert Lighthizer indicated he was encouraged by recent discussions and progress made regarding the divisive topic of automobile content with respect to NAFTA negotiations. The upbeat sentiment helped the Canadian dollar (CAD) retrace much of its early-March downward slide. The loonie broke above its recent range-bound trend this morning as news reports surfaced that U.S. President Donald Trump's administration may push for a preliminary NAFTA agreement that could be announced at next week's Summit of the Americas in Peru. However, in our view, a derailment in negotiations and weaker-than-expected data could again push the CAD lower. Scotiabank FX remains constructive on CAD over the longer term, but continues to see the possibility of short-term volatility tied in part to NAFTA-related developments. Notwithstanding the past two weeks, the Japanese yen (JPY) has held up year-to-date owing to lingering financial market uncertainty. A tit-for-tat tariff exchange between the U.S. and China has fuelled concerns about a global trade spat. In addition to its position as a safe-haven currency, the yen has been buoyed by ongoing expectations the Bank of Japan will eventually taper its current monetary stimulus.

***Economics:* Soft economic start to the year could leave the Bank of Canada (BoC) cautious; Global PMIs were mixed in March**

• The Canadian economy unexpectedly shrank in January, according to the month-over-month (MoM) GDP growth figure released by Statistics Canada last week. Total output fell by 0.1% on a MoM basis in January, largely due to slowdowns in the oil and real estate sectors. Output from the mining, quarrying and oil-and-gas extraction industry fell 2.7% in January, the largest decline since May 2016. Meanwhile, housing activity slowed during the month, with output from real estate agents and brokers slumping 12.8%, the largest monthly decline since November 2008. Canadian GDP growth is currently tracking at a level far below the BoC's forecast of 2.5% for Q1, and Scotiabank Economics expects a cautious BoC policy bias going forward. The next BoC monetary policy meeting is scheduled for April 18th and will be accompanied by an interest rate decision and release of the Monetary Policy Report.

• The latest batch of global manufacturing Purchasing Managers' Indices (PMIs) came in mixed for March. The U.S. manufacturing sector continued to expand last month, although both the Markit (act: 55.6 vs prev: 55.7) and ISM (act: 59.3 vs prev: 60.8) manufacturing PMIs showed small pullbacks from the previous month. Meanwhile, the Canadian manufacturing PMI beat February's reading (act: 55.7 vs prev: 55.6), while China disappointed and registered its weakest monthly reading on production and new orders in four months on the back of muted foreign demand. With major economies' PMIs released, we observed a dip in our PMI breadth index (percentage of countries with PMIs higher than 50) in March. 25 countries out of the 27 that have reported PMIs (92.6%) registered levels higher than 50 last month, down from 100% in February. Although fluctuations in the PMI breadth index are common within a business cycle, a sustained declining trend in the index could suggest a downshift in global economic momentum.

***Geopolitical:* Trade tensions, North Korea progress and Ontario budget are dominant topics**

• **The U.S. administration is now pushing to wrap up North American Free Trade Agreement (NAFTA) negotiations faster than previously thought.** Media reports suggest the U.S. administration would like to have a "handshake" agreement on NAFTA in place before the end of next week. That would allow for its official reveal at the Summit of the Americas in Peru that begins on April 13th. Yesterday's news would be an about-face after months of threats (including yesterday morning's) to pull out of the deal. It also comes after comments by Canadian officials last week indicating mixed sentiment about progress on negotiations thus far. Indeed, there has been no public signal that progress has been made on contentious issues including a sunset clause, auto content, or dairy marketing boards. The move may be an attempt by the White House to appease trade-reliant states ahead of mid-term elections and close one of the many geopolitical files (North Korea summit, Chinese trade relations) the administration has open at the moment. The Canadian dollar and Mexican peso reacted positively to yesterday's headline, but investors should watch for further volatility when Mexican Economy Minister Ildefonso Guajardo and Canadian Foreign Affairs Minister Chrystia Freeland attend meetings in Washington on Wednesday and Thursday of this week, respectively.

• **Ontario's new budget includes higher spending ahead of June's election.** Last week, Ontario tabled its 2018-19 budget, which includes large increases to program spending and a return to deficits. Total program spending increases from $137.5B in FY18 to $155.8B in FY21 and focuses on child care, OHIP+, a new Ontario Drug and Dental Program, mental health investment, hospital funding, and social and disability assistance. The effect will be a return to deficit spending (after years of deficit elimination effort, culminating in FY18's modest surplus) from FY19 to FY24 before a balanced budget is expected in FY25. This spending comes at a time when the Ontario economy is operating at or near capacity amidst strong growth just ahead of the spring election. This political strategy could prove successful but come at

a cost, especially if Ontario's economy turns and leaves the government depleted in its ability to deploy fiscal stimulus.

• The Chinese and North Korean governments had a secret summit ahead of U.S. talks. North Korean leader Kim Jong-un travelled to Beijing last week to meet with Chinese President Xi Jinping. The secret meeting (not announced ahead of time) marks the first of a number of summits with regional and global powers; North Korea has announced summits with the U.S. and South Korea and is said to be planning one with Japan. It seems North Korea is pursuing re-entry on the global stage by offering up the possibility of denuclearization after a year fraught with tension over missile testing. The recent meeting underpins the importance of Chinese involvement in future negotiations with the North Korean government.

Recommended Asset Allocation

Asset Class	Neutral	Tactical
Equities	**60%**	**65%**
Canada	30%	33%
United States	25%	25%
International	5%	7%
Fixed Income	**40%**	**30%**
Government/Prov's	25%	15%
Inv. Grade Corporates	10%	10%
High Yield	0%	0%
Preferreds	5%	5%
Cash	**0%**	**5%**

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

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