

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 tone improves on strong economic data; maintaining overweight equities

• **Strategy:** Global markets have rallied across most asset classes over the past couple of weeks including equities, government and corporate bonds as well as commodities while most currencies have gained against the U.S. dollar (including the CAD). The improvement in market tone has come on the back of positive economic data surprises globally, particularly amongst major economies such as China, Canada, the Eurozone and Emerging Markets. The broadening out of economic momentum beyond the U.S. into the rest of the world improves the resilience of the recovery cycle and has given investor confidence a shot in the arm in 2017. As a result, earnings prospects remain bright and confidence amongst central bankers to reduce current levels of monetary stimulus has firmed which has further bolstered the case for equity outperformance versus fixed income to continue over the coming year. Given our indicators suggest the next recession is not likely to materialize until 2019 at the earliest, we likely will retain our Overweight equity / Underweight bonds asset allocation strategy over the next 12 months. Given we are in the late stages of this economic cycle, which typically is characterized by strong economic growth, rising interest rates / bond yields and supportive commodity prices, a bias toward cyclical sectors (away from defensives) is maintained.

• **Equities:** Strong U.S. Q2 results (73% beat their respective earnings estimates with an average 7.6% surprise) and a rise in global bond yields (U.S. 10 year Treasury now at 2.3% and pointing higher) creates an ideal backdrop for a continued rise in the global equity bull market. We continue to hold our overweight view (from Q1'16) and believe a rotation into cyclically-oriented sectors offers the best opportunities at the expense of defensives. Sector-wise, we retain a preference for banks, insurance, brokers, energy, chemicals, metals, paper, communications equipment, select retail, autos, industrials, and health care. Geographically, we went overweight Europe in Q1 and believe the time has come to include Canada within that overweight discussion in view of improving commodity pricing.

• **Fixed Income:** Corporate debt returned to favour over the last few weeks. Yields continue to rise on strong economic data and oil prices, which caused spreads to fall in all sectors of the Canadian bond market. However after a strong showing from provincials, corporate debt once again outperformed all other segments. Indeed, risk-product was in favour as the spread between BBB and A-rated bonds narrowed, indicating a move by investors down the risk curve. We anticipated this return to a bias towards corporates, as we have long held our corporate overweight allocation. Going forward any corrections in spreads (absent material macro changes) should be considered buying opportunities.

• **Preferreds:** Momentum in the rate reset market has eased over the last couple of weeks following solid gains in June and first half of July. The recent softness in volumes is likely contributing to the recent sideways behavior of the market. The worst performing segment of the market has been the

straight fixed perpetual space as underlying 30-year bond yields face continued upward pressure. The floating rate segment continues to dominate the performance charts since the Bank of Canada's hawkish turn on June 12th. After remaining out of favor for the last several years, the floating rate segment has seen a significant rally in share prices as the market looks to gain from the outlook that the Bank of Canada will continue its path of tightening monetary policy. The market is currently pricing in the expectation of at least two rate hikes over the course of the next year. We remain constructive on the floating rate segment along with rate resets/fixed floaters that all benefit from rising interest rates.

Currencies and Commodities: Crude oil fundamentals appear to be improving; Further CAD gains could be limited

- WTI has increased nearly 8% from its July low as crude oil fundamentals appear to be firming. The U.S. Department of Energy (DOE) had reported better-than-expected inventory draws over the last three weeks, with crude oil inventories declining by 18.6 million barrels over the three week period versus expectations for a draw of 7.5 million barrels. Of note, as of last week's report, crude inventories were slightly below last year's levels. WTI prices received further support this week as the Saudi Energy Minister stated that Saudi Arabia would limit oil exports at 6.6 million barrels per day in August, which is about 1 million barrels per day below year-ago levels. Canadian energy equities have reflected the bullishness of the recent inventory reports and the latest Saudi export news. While we believe crude oil prices could remain volatile in response to a host of factors beyond U.S. supply/demand fundamentals (e.g. OPEC+ supply accord compliance), improved sentiment and the depressed state of many energy stocks could pave the way for a near-term rebound.

- The loonie continues to fly high, topping US\$0.80 this week on the back of expectations of further Bank of Canada rate hikes as well as a slightly more dovish U.S. Federal Reserve. While the Canadian dollar could continue this trend in the near-term, in our view, the majority of the move higher in the near-term is complete. Markets are currently pricing in 52 bps of rate hikes for Canada over the next year, while just 25 bps for the U.S. In our view, Canadian expectations

appear a bit optimistic while U.S. expectations do not seem optimistic enough, which, we believe, leaves the CAD in a vulnerable position. Absent additional catalysts such as a meaningful pickup in inflation in Canada or further dovishness from the U.S. Federal Reserve, ongoing concerns such as elevated consumer debt levels, an over-heated real estate market and volatile oil prices could weigh on the loonie's prospects for the remainder of the year.

Economics: Recovery materializing on upbeat data; Canada defining its value within NAFTA

- Global data continues to support our recovery thesis. Over the last two weeks strong economic data has confirmed the global recovery is strengthening. Canadian, U.K. and Chinese retail sales all beat expectations as did Chinese Q2 GDP. This has combined with consumer prices from Germany, France and Canada that indicate inflation may be bottoming. The data paint a picture of global recovery that we have been expecting for quite some time. Additionally, the breadth of the strong results implies durability to the recovery that gives us confidence for the second half of this year and beyond. We will watch for GDP results from Canada and the U.S. at the end of the week. Canada is expected to post a solid result for May on the back of wholesale, retail and export volumes, while the U.S. consumer could boost a second quarter rebound in the U.S.

- As expected, the U.S. delivered its list of objectives for NAFTA renegotiation. Those objectives were varied and listed in vague language, but included: improving the U.S. trade balance, Canada's supply management for dairy and poultry, increase in duty limit on U.S. purchases, and regulations in telecommunications and financial services. The verbiage suggests substantial uncertainty about the direction of the final product, but areas that pertain to the recently signed Trans Pacific Partnership could be used as a framework. In response, Canada's Foreign Affairs Minister Chrystia Freeland noted, "Canada is the top customer of the United States. Canada buys more goods from the U.S. than China, Japan and the United Kingdom combined." The statement seemed to send a clear reminder to participants that Canada knows its worth in the NAFTA landscape. There is likely plenty of room for

jockeying and speculation about the impact on the Canadian economy ahead of the start of official negotiations on August 16th.

Geopolitical: American Health Care Act bites the dust

- Last Monday it was announced that the American Health Care Act (AHCA) had met its demise. A total of four U.S. Republican Senators voted against their own party to defeat the bill championed by Senate majority leader Mitch McConnell. The bill will be replaced with a vote to repeal Obamacare with a two-year delay. However, despite pleas from the U.S. Commander in Chief, the repeal vote reportedly does not have the necessary number of proponents to pass. The failure of the American Health Care Act is likely to be seen by many as further evidence of the Trump Administration's inability to transform campaign promises into law.

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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