

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: Staying with strategy settings for 2017 – equities > bonds, cyclicals > defensives. Possible near-term pullback in Q1 part of bullish medium-term trend.

• **Strategy:** Global markets ended 2016 on a strong note with equity markets posting solid gains in the month of December (S&P500: +1.97%, TSX: +1.66%, Euro Stoxx 50: +7.94%), while commodities continued to march higher led by oil prices and fixed income continued to underperform as bond yields remained on an upward path. Certainly for full-year 2016, broad market performance largely followed our portfolio strategy settings of overweighting equities (S&P500: +11.95%, TSX: +21.08%) and underweighting fixed income (U.S.: +2.61%, Can.: +1.66%). Through the first couple of weeks of trading in early 2017, equity markets remain perched at or near all-time highs as investors digest a recent string of solid global economic growth data while awaiting a number of important events and developments to set the tone for coming weeks and months. Prime among these is the inauguration of the new U.S. president (Jan. 20th) and his administration's new policy direction. With equity markets and bond yields having witnessed large gains in recent months, a profit-taking driven pullback (or sideways churn) characterized by rapid sector rotation could materialize in the first quarter of 2017 as investors seek confirmation of anticipated bullish developments including plans for fiscal stimulus in the U.S., oil prices remaining above US\$50/bbl,

improving corporate profits, etc. We would see this as a natural pullback within our long-held bullish medium-term view on equities with an overweight in cyclical sectors (see our Portfolio Compass 2017-Q1 report for full details of our global investment strategy).

- **Equities:** With the intra-cycle earnings recession likely having ended in Q3, the market eagerly awaits positive YOY earnings growth from the upcoming earnings season. Some of the big US banks will be reporting Q4 results on Friday, January 13th. Stronger economic activity (auto sales, construction, jobless claims) and firming commodity prices (metals, oil) should help propel Q4 earnings higher. Latest ISM numbers point to corporations being able to pass higher input costs through to end users; helping to stem investor-fears of deteriorating profit margins. The strongest EPS recoveries remain with the most beaten down sectors like Banks, Energy and Autos and that is where we remain most bullish.

- Our equity implementation strategy has not changed as regionally we still generally prefer North America over Rest-of-World and sector-wise we remain overweighted to Energy, Materials, Financials, Industrials and Small Caps at the expense of Telcos, Utilities, Staples, REITs, and Gold. We are neutral on Technology, Discretionary and Health Care and see the recent bounce as a tactical one relative to our preferred sectors. In a similar vein, the recent tactical bounce in defensives/rate-sensitives, which we have forewarned in previous HWWT reports, should be used to trim and reallocate toward cyclicals.

- Lastly, inter-stock correlations continue to decline as a result of global monetary easing passing the "policy-baton" over to fiscal stimulus which



Enriched Thinking™

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traditionally benefits certain industries over others (an advantage for active investing). In our view, Active investing should enjoy further tailwinds (latter-stage bull market, end of QE) after years of being condemned by the Passive investing movement.

- **Fixed income:** As expected, yields tightened in over the holiday season. Additionally, steepening from the “Trump Trade” abated as the spread between 2s and 10s has narrowed. This pause in reflation was likely warranted after the sell-off to end 2016; however we still see upward pressure on rates in the near/mid-term. As such we continue to recommend defensive rates positioning with portfolio duration shorter than the overall index (7.38 years), around 5 years. On the corporate side, we continue to believe the credit environment will continue to be accommodative. Since our last edition spreads on corporate A and BBB credit have tightened, which we expect to continue. Additionally spreads on BBB have tightened more than those for A rated credit indicating a further risk-on shift within fixed income. For those reasons we recommend overweight corporate credit and underweight provincial and government debt.

- **Preferreds:** The preferred share market ended 2016 on a high note driven by improved global sentiment and higher bond yields. In the last two months of the year Canadian yields across the mid to long end of the curve increased between 40-50 bps benefitting from an improved growth outlook in the U.S. vis-a-vis a Trump Presidential victory and a more hawkish Federal Reserve. This sudden and drastic improvement in 5-year yields sparked greater demand for the rate reset product, which benefits from rising base rates, driving share prices higher. We expect demand for rate resets to remain strong in 2017 on both the new issue and secondary market fronts with the expectation that Canadian mid to long-term yields will trend higher throughout the year alongside their U.S. counterparts as growth prospects in the U.S. improve and the Federal Reserve looks to raise rates three times. The outlook for the Canadian economy also looks to be improving alongside an oil price recovery and recent employment and trade data, which has all, but eliminated the likelihood of near-term rate cuts from the Bank of Canada. Unlike rate resets that should benefit from rising yields, straight fixed perpetuals are negatively influenced by rising long-term yields

hence their lagging performance into year-end. Floating rate preferreds should benefit from an improving outlook in Canada; however, we expect short-term rates to remain anchored to monetary policy in Canada, which we expect to remain on hold throughout 2017. We currently favor rate reset preferreds over floaters as we see greater upside in 5-year yields than short-term yields. However, we are comfortable adding floating rate exposure for medium term investors as we see limited downside risks from current levels with greater upside potential should the Bank of Canada start to take a more hawkish stance potentially into latter half of 2017.

Currencies and Commodities: Canadian dollar brushes off weaker oil to start the year

- WTI has had an eventful start to the year which has resulted in an overall 6% decline YTD. The commodity reached an 18-month high of \$55.24/barrel on the second trading day of the year, but aggressively sold off ~\$3/barrel over the following few hours. There were many plausible explanations in the marketplace on what caused the sell-off including concerns over OPEC/non-OPEC producer commitment to the supply accord, increasing Libyan supply, and a higher USD. Crude rebounded over the next few days, but continued its decline this week on strong rig count additions and concerns over rising Iraqi output. Given the fluctuations thus far, what is inherently clear is that headline risk will result in continued oil price volatility over the first six-months of the year (term of initial supply cut/freeze agreement). However, our expectation is for WTI to trade, on average, in the US\$50-US\$60/bbl range in 2017, provided there is some level of compliance with the supply agreement over this period.

- Natural gas has had an even tougher start to the year, down 11% YTD. The decline can largely be attributed to warmer-than-expected forecasted weather across North America. The Energy Information Administration (EIA) storage report last week did not help the commodity either, reporting a draw of only 49 Bcf, consensus was looking for a draw of 77 Bcf. Given the extreme volatility in natural gas, we recommend investors focus on high quality producers with prudent hedging strategies.

- The Canadian dollar is having a solid start to 2017, up 2% YTD versus the USD, brushing off the crude oil

weakness. A pair of very strong economic data releases to end the week supported the quote. The Canadian job numbers for December blew past expectations, while the November trade balance was much better than expected on the back of strong export volumes. We believe there will be numerous gives and takes, such as supportive oil prices, receding trade risks and diverging monetary policy relative to the U.S., which should keep the CAD range-bound over the medium-term.

Geopolitical: Chinese Power Consolidation and European Uncertainty

- This year will mark 5 years of power for Chinese president Xi Jinping. With that anniversary will come the twice-a-decade meeting of communist party leaders where among other topics, succession will be discussed. However there is popular thought that Xi – who leads with “the Putin model” – may change current rules to continue his reign. Since taking over from Hu Jintao, President Xi has centralized control of the party, claimed additional titles of party chief and military commander, and warned against senior officials who “lusted for power.” He has also stated

he “wants to keep going” despite rules that require retirement after the age of 67 (his term expires in 2022 when he will be 69). Leading up to the meeting in the fall it will be interesting to see how Xi further consolidates power in order to influence his future as China’s President.

- 2017 will also be an interesting time for Europe. Elections in the Netherlands, France, Germany and possibly Italy will bring political uncertainty that could increase Euroskeptic power in the bloc’s most important economies. Add to this Brexit negotiations which could see the U.K. sign a new trade agreement or agree to Europe’s customs union. Finally, as France’s spring elections near, temperatures will rise and renew immigration issues. All of these forces will contribute to an uncertain future in Europe which we will tackle as the events near (first up are Netherland elections in March).

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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