

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: Headline noise to remain elevated in the near-term; Positive earnings and revenue momentum to continue through 2017

- **Strategy:** Global markets have continued to notch impressive gains thus far in February with North American equities outperforming (S&P500 +3.6%, TSX: +3.2%, EuroStoxx50 +3.0%, Nikkei: +1.8%) while fixed income held steady following several months of rising yields. In our view, fundamentals remain constructive for risk asset classes to perform well in 2017. These tailwinds include strengthening economic growth momentum, declining volatility, rising inflation and bond yields, low recession probabilities, improving flow of funds into equities, recovery in earnings growth, etc. However, headline noise is likely to remain elevated on a number of fronts in the near-term in a busy calendar which includes President Trump's address to a joint session of congress (Feb. 28) which should include an update on tax reform prospects, Secretaries Tillerson & Kelly meet with Mexican officials (Feb. 22-23), healthcare repeal & replace plan expected to be announced (week of Feb. 27th), UK PM May could trigger Article 50 to begin negotiations on the UK's exit from the EU just ahead of or at the EU summit (Mar. 9-10), Netherlands' national elections (Mar. 15), and the Fed's policy meeting (Mar. 15). Our portfolio strategy preferences remain unchanged - overweight equities versus fixed income and maintain a cyclical/reflation bias to sector and style exposures (energy, materials, financials, industrials, value, etc.). We would view any

material pullback in markets as an attractive buying opportunity.

- **Equities:** Fourth-quarter earnings reports have provided markets a continued stream of good news in recent weeks. As of today, 87% of companies have reported in the U.S. and the Q4 blended earnings (actual + estimated) are now growing at 4.6% y/y and blended earnings growth for Q1'17 is expected to be 9.6%. In comparison in Canada, 41% of companies have reported and Q4 blended earnings (actual + estimated) are now growing at 27.1% y/y and blended earnings growth for Q1'17 is expected to be 36.4%. We believe earnings and revenue momentum should remain positive for all of 2017 and perhaps into 2018. As far as our market outlook, longer-term indicators are still pointing towards higher equity prices in the medium and long term and as such any short term weakness in our opinion will only be in the mid-single digits and difficult for most investors to time. We continue to be cyclically oriented but recognize the entire market is participating in a very broad way. Our overarching fear however is for rising yields as the world moves away from a zero rate environment and the long term implications for defensive stocks (expensive and crowded).

- **Fixed income:** Upward pressure on yields has eased, as has the pace of spread tightening. Over the past two weeks we have continued to see our expected trends –increasing yields and spread tightening – continue. However this has been occurring at slower rates than previous months. While we believe our medium/long term outlook remains the same this could be an opportunity to revisit current corporate spread levels. As we have mentioned in the past, spreads on A and BBB rated corporate debt have experienced almost



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uninterrupted tightening over the last 12 months. However since the beginning of the year, this has slowed and leveled off. At this point we would not be surprised if participants took the opportunity to take profits, resulting in a correction and widening of spreads. Despite this potential healthy correction we still believe our thesis of improving credit over the long/medium term remains intact. Thus we would recommend buying on any pullback. We continue to recommend an overweight in corporate debt with exposure to floating rate product.

- **Preferreds:** The preferred share market has been relatively flat over the last couple weeks following two strong weeks of performance. Rate reset demand has continued to be strong although softer than volumes experienced in January. The softness in the market throughout the second week of February was a function of falling 5-year bond yields, which reached a year-to-date low on February 8th at 1.01%. The approx. 16-20 bps recovery in underlying 5-year Gov't of Canada yields since the bottom has helped drive a rebound in rate reset prices. We expect price volatility to persist alongside movements in underlying bond yields. Although we expect pockets of flight to safety to lead yields lower, we see the overall trend in bond yields pointing higher as we expect to experience a further improvement in global growth over the next 12-18 months alongside tightening monetary policy in the U.S. We still see the most opportunity going forward in rate resets that should continue to perform well in a rising interest rate environment. We prefer to be positioned in longer-dated rate resets as we see a benefit in having a longer-time horizon to reset in order to increase the likelihood of receiving higher dividend rates upon extension than if reset at rates today. A rising yield environment also should help to drive credit spread improvement and thus lower risk premiums in many industries; specifically Financials and Energy, both of which comprise a large percentage of the overall market.

Economics: The Fed is keeping all meetings live, meanwhile international economic environment also improved.

- Following strong economic data since the beginning of the year, the Fed seems to be moving closer to its first rate hike of 2017. While the Fed Funds futures

market is signaling a May hike (the first FOMC meeting with a probability of rate hike higher than 50% @58.7%), the central bank is trying to keep the March meeting (@36%) live as well. Fed officials including Harker, Mester and Yellen herself have shown confidence in the U.S. economy and the Chair indicated that she foresees additional tightening this year regardless of whether President Trump follows through on plans to pursue pro-growth fiscal measures. Inflation pressures could be another factor pushing the Fed to hike sooner than previously expected. The Fed's preferred gauge of inflation, the PCE deflator, rose to 1.6%y/y in the 12 months through December, up from 1.4% in the year through November and the number is expected to jump to 2% in January (data to be released on March 1st), reaching the Fed's inflation target. With the next FOMC meeting scheduled for mid-March, there are still more data to come before then including February CPI and labour market data as well as manufacturing indices.

- Outside of the U.S., economic environments in Europe and Asia have also improved since the beginning of the year. Eurozone CPI for January came out in line with expectations and manufacturing PMI beat estimates. In China, both CPI and PPI surprised on the upside. Meanwhile, Chinese bank loans in January came out higher than the previous month, mostly due to the renewal of lending quotas at the start of the year, while the number was well below January last year and short of economists' estimates. This reflects the recent monetary tightening by the PBOC which pushed interbank interest rates higher. Beijing's stance of a higher tolerance of slower growth as indicated back in December suggested that policymakers would not protect growth at all costs with debt-fuelled investment anymore. There is also growing expectations that the Chinese government has plans to expand its infrastructure spending, which would further drive up commodity prices, while at the same time cut capacity by merging state-owned enterprises and shutting down unprofitable facilities. This would help to form a leaner economic structure and a healthier growth path. China's cabinet is set to release official targets for GDP and broad money growth at its two-week annual parliamentary session commencing on March 5th and investors will look

forward to signals from the government on its bias towards tightening.

Currencies and Commodities: Copper continues its move higher. Oil tries to break out of trading range.

- Copper continues its rapid move higher, up 9% YTD and 31% from its October 2016 lows as both demand and supply side forces are driving the surge. Growing demand from China, which consumes ~40-50% of the world's copper supply, as well as speculation of increased demand from the U.S. on the back of the Trump administration's proposed infrastructure spending plan, has supported the demand outlook for copper. On the supply side there have been two notable supply disruptions: (1) a worker strike at BHP Billiton's Escondida mine in Chile and (2) reduced operating rates at Freeport-McMoRan's Grasberg mine in Indonesia related to a yet-to-be reached export agreement with the Indonesian government. The Escondida and Grasberg mines account for 10% of the world copper supply. In our view, while the supply side disruptions are temporary, we expect the demand picture to remain supportive of copper over the medium-term as the global economic backdrop continues to improve.

- WTI is attempting to break out of its relatively tight trading range of US\$52-\$54/barrel that has held for the majority of this year, with the commodity rising 3% since our last HWWT report on February 7th. The move in WTI is likely attributable to the International Energy Association's (IEA) data release on February 10th which indicated that OPEC supply cuts have exceeded expectations and that the global crude oil market is tightening. The IEA now estimates that global supply-demand balances will be in an 800 kbbl/d deficit in the first quarter of 2017. This further supports our expectation for WTI to trade, on average, in the US\$50-US\$60/bbl range in 2017. We do note, however, that as crude prices creep higher, US production is likely to follow suit, potentially limiting significant upside beyond US\$60/barrel.

- The Canadian dollar is largely flat since our last publication, as weaker-than-expected retail sales data from this morning erased most of the gains over the last two weeks. Nonetheless, the CAD has appreciated by ~2% versus the USD on a year-to-date basis. If crude does break-out of its recent trading range, we could see continued strength in the CAD in the near-term; however, our medium-term view remains unchanged. We expect diverging Canadian monetary policy relative to the U.S. to offset rising crude prices, keeping the CAD range-bound (\$0.70-\$0.80).

Geopolitical: Trudeau Makes the Rounds

- Since we last updated, Prime Minister Trudeau has been busy meeting global heads of state. On February 13th, PM Trudeau met with U.S. President Trump to talk about subjects including trade and women in the workplace. From the press conference that followed it seemed the two had an amicable report while PM Trudeau held his ground on differences in immigration policy. While nothing formal came out of the meeting, the tone of the press conference likely calmed Canadian concerns over Trump's anti-NAFTA sentiment while also presenting Trudeau as a trusted neighbour. This position could prove beneficial to Trudeau on the international stage. On February 17th the Prime Minister concluded a trip to France and Germany to celebrate the ratification of the Comprehensive Economic and Trade Agreement (CETA) between Canada and the E.U. While in Europe he met with German Chancellor Angela Merkel and discussed topics including, economic and foreign policy issues, CETA, and international security concerns. No doubt Trudeau's unique position with President Trump was folded into at least some of that conversation. It was also likely to have framed the conversation between Canadian Foreign Minister Chrystia Freeland and Mexican Secretary of Foreign Affairs Luis Videgaray when they met on February 21st.

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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